Pensions Today and Tomorrow:

An Ontario Economic Council Position Paper

Special Research Report

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Preface

In the fall of 1982 the Ontario Economic Council decided that pensions and pension reform constituted an issue of sufficient importance to Ontario and Ontarians to merit detailed analysis on our part. The focal point of our research effort was the release of the federal government's 'Green Paper', Better Pensions for Canadians. Survey and background papers relating to the pension area were commissioned and these were presented and discussed at an August, 1983 conference in Toronto. These papers will be published shortly in an OEC volume, Pensions Today and Tomorrow: Background Studies.

The document, written by our Chairman, Thomas J. Courchene, represents the Council's position with respect to pensions and pension reforms. As might be expected, the drafting of the document went through numerous iterations as Council members presented detailed analyses and criticisms of the successive versions of the manuscript.

Those of us who have appended our signatures to this document have signalled our acceptance of the basic thrust of the position paper. However, this does not imply that we all agree with each and every recommendation contained in the report. Indeed, there are probably sections that some Council members will disagree with. As will become very evident upon reading this or any other pension document, pension reform is among the most politically and emotionally charged public policy issues. Not surprisingly, it was not possible to generate Council unanimity on pension reform. Council members who disagreed with the overall thrust of this position paper were encouraged to append their own views to the document.

In drafting this report, we relied heavily on the background studies. Indeed, we felt free to reproduce their analyses and perspectives where relevant, often without attribution. A list of those who contributed to the background studies is also appended to the report. We wish to thank Alex Scala for his competent editing within our tight time schedule. Similarly, it is a pleasure to acknowledge the magnificent effort expended by the Council staff in the preparation of this document and, earlier, in running the Pension Conference. Our Research Director, David Conklin, provided guidance and encouragement in the drafting of the report and our Administrative Officer, Sharon Wahl, coordinated Council members' inputs into the process of generating the final document. We also wish to thank Brenda Huff, Publications Officer, who did an excellent job in supervising the mechanics of the production process in an extremely short span of time. Also, special thanks to our word processing crew, Tom Gerylo, James Leahy, Sylvia Machek and Kathy Ashenden.

A summary of an earlier version of this document, authored by our Chairman and by David Conklin, was presented to the Parliamentary Task Force on Pension Reform.

The Council believes that the range of issues associated with pension reform are among the most important issues with which present and future Canadians will have to come to terms. We cannot be absolutely sure that the analysis that follows represents the ideal approach to pension reform. However, we are satisfied that we are fulfilling the Council's mandate to apprise Ontario and Ontarians of issues that are critical to their present and future economic well-being.

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††Mr. Pilkey is not in agreement with the thrust of this report. His views are appended to this document.

Part 1

Pensions: Introduction and Summary

1
Introduction and Summary

Canada is currently in the throes of a heated debate about pensions and pension reform. There can be no unanimity of views, since the issues at stake are fundamental. At one extreme, the debate embroils itself in ideological concerns. Should saving for retirement be compulsory or should individuals have freedom to choose between present and future consumption? Should income support for the elderly be universal, or should it be targeted to those most in need? In terms of the society as a whole, what is at issue is nothing less than the role of the state in the 21st century: compulsory expansion of the public pension system would have a dramatically different effect on capital markets, on resource allocation, and on the relationship between the citizen and the state than would a reform of the private pension system.

There is, however, much more than ideology at stake. Issues relating to fairness or equity are also prominent. Is it appropriate for some people to have access to indexed pensions when others do not? Is it appropriate for some segments of the elderly to have levels of income support that leave them below the commonly recognized poverty line? Of particular concern is the issue of equity between generations. The unfunded liabilities already incurred under the Canada Pension Plan and the Quebec Pension Plan are five times the value of accumulated assets. Is it appropriate to saddle future generations with further cost transfers on an even larger scale by embarking on an expansion of the CPP?

Pension issues also interact with the current state of the economy and the current stance of fiscal policy. Given the recent slowdown in both real income growth and productivity, how much of national income should society transfer to the elderly? This is a particularly difficult decision in light of the demographics, which suggest that an increasing proportion of society will fall into the 65-plus category as we approach the 21st century.

On the fiscal front, one of the appeals of an expanded CPP is that, initially, contributions would exceed benefits, generating surplus funds which could be funnelled into current fiscal operations. Should pension funds be diverted to governments' operating budgets?

Pensions are also frequently seen as a major instrument of social policy. Accompanying the federal Green Paper on pensions was a smaller companion piece entitled 'Focus on Women'. Should the CPP be extended to homemakers? Should credit-splitting of pension assets between spouses be mandatory at age 65? In general, how far should the pension system go in addressing social issues?

In terms of the perennial division-of-powers issue in Canada, the question is which level of government should regulate pensions. Can the provinces co-operate to ensure pension portability sufficient to make labour markets truly national? Should provincial pension funds be able to acquire equity ownership in interprovincial enterprises such as transportation companies?

While the litany is endless, the issues raised in the previous paragraphs are sufficient to make the point that there can be no unanimity of views among Canadians on these issues. It should come as little surprise, therefore, that the members of the Ontario Economic Council are also not unanimous in their views on pensions and pension reform.

The Council became interested in the topic because pensions are of utmost importance to Ontario and Ontarians. After the federal government published its pension document, Better Pensions for Canadians (henceforth referred to as the Green Paper) in 1982, the Council commissioned a series of background papers on various aspects of pension reform. In August 1983, the Council held a small conference at which these papers were presented and discussed. The papers will be released shortly under the title Pensions Today and Tomorrow: Background Studies. In what follows we shall refer to this book as the Council's background document. Needless to say, we shall draw heavily and often without attribution from the various pieces in this background document. However, the present document is not really a substitute for the wealth of information and insight in the background studies.

The present document is rather long, in part because we wanted it to be self-contained and in part because the issues involved are so varied and complex. The remainder of the introduction is devoted to an overview-cum-summary of what follows. To the end of each chapter we have appended a set of Council summary observations. For convenience, these observations are pulled together below to provide an executive summary of the document.

COUNCIL SUMMARY OBSERVATIONS

PART I: PENSIONS: INTRODUCTION AND SUMMARY

Chapter 1: Introduction and Summary (no summary observations)

PART II: PENSIONS: THE STATUS QUO

Chapter 2: The status quo: an overview (no summary observations)

Chapter 3: Private pension plans

- Approximately one-half of working Canadians are members of occupational pension plans. Most of these workers belong to defined benefit plans of one kind or another, rather than to money purchase plans. The coverage rate is too low, and some reform is warranted on coverage grounds. We shall have much more to say on this issue in later chapters.

- It is important to recognize that pension plans are an integral part of incentive-oriented, long-term labour contracts. In particular, they typically play an important role in facilitating on-the-job training and other investment in workers' human capital.

- Economic analysis suggests that workers will bear the costs of pension reform. While reform measures will enhance the ability of workers to provide for their retirement years, they should be introduced with an eye to minimizing the impact on pre-retirement income and the accumulation of skills.

- Legislation that applied retroactively could saddle employers with some of the costs of pension reform. However, the Council is adamantly opposed to retroactive reform measures.

- Some public sector pension schemes are not fully funded plans but rather consolidated revenue plans. It is inappropriate to use the benefits these plans provide as a standard against which to measure private sector plans unless one also takes into account the actuarial cost of these benefits. Recent estimates suggest the federal government would have to set aside an additional 11.3 per cent of its total payroll over a 15 year amortization period to cover the unfunded liabilities in its pension plans.

Chapter 4: The public pension system

- Unlike occupational pension plans, the public pension arrangements are not contractual in nature. This description applies even to the CPP/QPP. Rather, the public pension system tends to be characterized by intergenerational transfers.

- The public pension system incorporates the dual objectives of income support and income replacement. Since these objectives can be in conflict, it is not surprising that the many programs composing the public pension system sometimes generate peculiar or perverse incentives (e.g., GIS-GAINS tax-back rates).

- In terms of dollars, OAS, and not the CPP, is the backbone of the public pension system. This will remain the case even when the CPP matures.

- The CPP incorporates an immense transfer of costs to the next generation. Under current contribution and benefit schedules, an individual who contributes for 42 years will have 'paid' for roughly one-half of the value of his retirement pension.

- For all intents and purposes, the present public pension system produces a flat distribution of benefits for those with no other sources of income. Thus, the addition of a maximum CPP pension of $4,141 to the income of an elderly couple increases the couple's overall annual income by only $162. This outcome is a result of the interaction between the goals of income suppport and income replacement.

- Some features of the public pension system do not appear to be consistent with either income support or income replacement. For example, the age and pension deductions under the provisions of the income tax regulations deliver benefits that increase with increasing income.

Chapter 5: RRSPs

- RRSPs are very flexible instruments capable of performing multiple functions - income averaging, tax deferral, income-splitting between spouses, and sheltering of income for retirement.

- RRSPs are used principally by high-income taxpayers. Of persons with incomes above $35,000, over 50 per cent make contributions to RRSPs. For persons with incomes below $12,000, the rate of contribution is well below 10 per cent. In addition, the average dollar contribution rises with the level of income.

- There are at least two reasons why RRSPs are more attractive to high-income than to low-income people. First, since contributions are tax deductible, the after-tax cost of contributions falls as a person's marginal tax rate rises. Second, the RRSP benefits of those who cannot put much income away for retirement would be subject to the high or confiscatory tax-back rates associated with GIS-GAINS.

- If RRSPs are deemed to be principally vehicles for enhancing retirement savings, then two modifications seem appropriate in the interests of 'fairness': first, the present tax deduction approach might be converted to or supplemented by a refundable tax credit approach so that all Canadians, regardless of income class, would have an incentive for putting funds in RRSPs; second, some minimum contribution levels might be introduced, up to which all Canadians would have a right to contribute. The latter provision would imply that if people did not take advantage of RRSPs early in their working lives, perhaps because of adverse income prospects, they would be able to make retroactive payments up to this minimum level later in their working lives. This minimum lifetime contribution level would appear to be a natural companion to the Green Paper's recommendation for maximum lifetime contribution limits.

Chapter 6: Financial implications of the existing public programs

- The existing pension system incorporates very substantial transfers of costs to the next generation. For example, one recent estimate suggests that of the $115 billion worth of pension promises already accrued under the CPP by the end of 1981, only $20 billion is backed by provincial indebtedness. The intergenerational transfer is much larger for the OAS program.

- The present set of public pension arrangements (the combination of tax and contribution rates on the one hand and the structure of benefits on the other) is simply not sustainable. Maintaining the present structure of benefits into the 21st century would require a very substantial increase in taxes and/or contributions. Maintaining the present tax and contribution structure would require a substantial rolling back of benefits to the future elderly. The status quo cannot be maintained. Moreover, any decisions that are made will, of necessity, have to incorporate judgments relating to intergenerational equity.

- Most of the discussion of the financing problem of the public pension system is conducted within the context of the CPP/QPP. This is far too narrow a framework. Even on maturation, the financial implications of the CPP/QPP will, under the present structure, be smaller than those associated with either OAS/GIS or the health costs of the elderly.

- Substantial uncertainty attaches to the forecasts of the proportion of the population that will be over 65 in the 21st century. Unfortunately, any forecasting errors will be cumulative - not offsetting - in terms of their cost impact. Underestimating the proportion of the population that will be over 65 would not only increase the financing requirements for all public sector pension arrangements but also spread the costs of this support over a smaller-than-estimated work force.

- With respect to the CPP, there are important decisions to be made relating to the present provincial indebtedness. On one interpretation, the CPP is essentially on a pay-as-you-go basis now. The only question is which level of government will levy the tax or contribution increases.

- More generally, the public pension system is non-contractual in the sense that present governments cannot bind future governments with respect to either the financing or the benefit structure. This being the case, a principle underlying the Council's approach to these issues is that any modifications to the structure of public pensions should be designed with an eye toward maximizing the probability that future Canadians will find them reasonably equitable and that future governments will, in consequence, honour them.

Chapter 7: Income support and the elderly

- Many of the elderly receive substantial non-government income (in the form of earned income, investment income, and private pension income) and many have accumulated substantial wealth.

- Nonetheless, there are also substantial segments among the elderly that are almost totally dependent on government income support.

- The use of Statistics Canada's low-income cut-offs as a guide (difficult to interpret as they may be) suggests that the public pension system is far more generous to the married elderly than it is to the single elderly.

- The public pension system provides support for married couples that is in all cases above the low-income cut-offs (Table 5). In all cases, the support for single pensioners provided by the public system is below these cut-off levels.

- The majority of these single pensioners are women.

- Within this category of low-income single persons there may still be many with adequate living standards. There is simply not enough information available to construct an overview position of the living standards of the elderly that would take into account such things as home ownership, access provided by various provincial governments to renter-assisted accommodation, etc.

Chapter 8: Income replacement and the elderly

- Canadians should have the opportunity to provide for adequate income replacement on retirement.

- Adequate income replacement is not the same thing as adequate income support. Income replacement ratios for low-income workers could exceed 100 per cent and still leave such workers below a generally accepted poverty line. Similarly, high-income elderly may have adequate income support even if their income replacement ratios are well below 100 per cent.

- The issue is, in part at least, whether governments should require Canadians to achieve specific replacement ratios or whether Canadians should have a choice between current consumption and retirement income. At one extreme, this issue boils down to the question of whether pension reform should incorporate a mandatory expansion in universal pensions in either the private or public system.

- In terms of 'gross' replacement ratios, the Canadian public pension system compares very favourably with those of other countries for persons earning one-half of the average industrial wage (AIW). Canada's public pension system generates progressively lower gross replacement ratios, relative to other nations, as pre-retirement earnings levels rise.

- Replacement ratios, calculated appropriately (that is, in terms of disposable income), are higher than is generally perceived. Indeed, on average, most Canadians earning the AIW (whether individuals or single- or double-earning couples) can come close to or even exceed 100 per cent replacement. Replacement ratios rise for persons earning less than the AIW.

- To be sure, replacement rates in the area of 100 per cent may not be available to all Canadians. The question is whether on grounds of fairness or some other criteron this situation requires a mandatory expansion of the public pension system.

PART III PENSIONS: THE REFORM AGENDA

Chapter 9: The Green Paper proposals (no summary observations)

PART IV PENSION REFORM: EVALUATING THE PROPOSALS

Chapter 10: Mandatory pension expansion: an evaluation

- The Council's priorities in pension reform are: first, enhancing income support for those elderly currently in most need; second, ensuring that workers at or below the average industrial wage have increased access to, and incentives for, retirement saving; third, ensuring that all Canadians have access to adequate retirement savings vehicles, so that post-retirement income will maintain a reasonable relationship to pre-retirement income.

- A mandatory expansion of the CPP/QPP or the private system would have some advantages. It would ensure greater coverage and portability than would non-mandatory private sector reform.

- However, a compulsory expansion of the CPP would also incorporate several critical flaws.

- An expanded CPP would not address our first priority, namely enhanced income support for those elderly currently most in need.

- While an expanded CPP would ensure coverage of some low income workers not currently part of occupational plans, because of the existing income-support delivery system these people are precisely the ones who would benefit from a CPP expansion least.

- An expanded CPP, partially funded, would transfer the bulk of the financing to the next generation of workers. Given current arrangements, this would in effect amount to a transfer to the presently well-off from future workers, both rich and poor.

- A fully funded CPP expansion would remove the above concern, but an investment policy geared to government debt or government priority financing would generate a rate of return to pensioners substantially below market rates. Over the recent past, the rate of return in the CPP 'fund' was 5 percentage points below the return on the average private pension plan. A compulsory expansion of the private system would earn market rates, but the Council does not feel that the current pension problems warrant this degree of modification and/or compulsion.

- Finally, an underlying motive for expansion of the CPP may be a desire to bring pension surpluses into the current budgeting process. Diverting a pension fund in order to service the general revenue needs of governments does not enhance fiscal planning, nor does it ensure an adequate and fair return to either pension contributors or beneficiaries.

Chapter 11: New coverage data

- Pension coverage is low for those aged 25 and under and whose earnings are less than one-half the average industrial wage, even under public sector plans.

- For those 25-44 and earning one-half of the average industrial wage or more, coverage increases dramatically, although for some cells the private sector coverage is well below that of public sector plans.

- The coverage problem does not appear to be a male vs. female issue per se. Overall, females have less coverage because so many of them are concentrated in low-income positions. The Council believes that public funds are better spent attempting to improve females' present income position than their future (retirement) income position. An improvement in the former will automatically improve the latter. However, the proposals in the remainder of our document should serve to increase coverage rates for males and females alike.

- The Council notes that the CPP may do very low income persons more harm than good. It decreases their current income and employment prospects and does little or nothing to increase their retirement incomes. If and when contribution rates rise, the regressive nature of this situation will be amplified. Accordingly, the Council feels that some consideration should be given to raising the annual income level at which people must belong to the CPP. Moreover, in Chapter 17 we shall suggest modifications to the present income support arrangements that would alleviate somewhat the regressivity embodied in the CPP.
- In general, the target group for pensions should be those persons 25 years of age and above with earnings at or above one-half of the average industrial wage.

Chapter 12: RPAs

- Registered Pension Accounts (RPAs), essentially RRSPs into which employers can also contribute, represent an important innovation. Their introduction would serve to increase both the quality and quantity of private pensions.
- Small businesses currently unwilling or unable to implement occupational pensions would likely be attracted to RPAs. Even firms that currently provide pension plans might wish to convert their plans to the RPA format, particularly if they have a mobile labour force and are saddled with administering scores of small deferred entitlements.
- RPAs would be ideally suited to the mobile worker, since the pension would be carried and administered by the worker and not the employer.

- Regarding the characteristics of RPAs, the Council recommends the following: RPAs should be allowed to invest in a broad range of assets; multiple RPAs should be allowed in order to facilitate portfolio diversification and the spreading of institutional risk; the range of financial institutions allowed to offer and/or administer RPAs should be as broad as possible; full disclosure, including performance appraisal, should be required.

- RPAs could be used to allow each worker the right, over his working life, to shelter some minimum amount of income in tax-assisted savings. Thus, if a worker experienced lean times over his early working life, but later received higher earnings, he could be allowed to shelter income, retroactively, up to some agreed-upon minimum. Such an arrangement would go some way toward satisfying the 'fairness' criterion that motivates much of the Green Paper.

- RPAs have the potential to increase worker pension awareness, since the money purchase nature of the plan would make contributors fully aware of their present and future pension status. Moreover, because RPA would be controlled by individuals, they would push out asset ownership widely, thereby decreasing the degree of asset control by large private pension pools.

- While locking-in appears to be one of the sacred cows in the pension debate, the Council recommends that governments take a fresh look at the issue. This is particularly important in light of the fact that implicit if not explicit in the Green Paper proposals is a rather dramatic increase in the degree to which pensions are locked in. It is probably important to ensure that the various retirement savings devices have similar locking-in provisions. At present they do not. Among the many alternatives worth considering is having all tax-assisted retirement vehicles embody compulsory locking-in at, say, age 40 and not before.

- RPAs could provide the backbone for a compulsory expansion of private pension plans. While this would be preferable to a compulsory expansion of the CPP/QPP, the Council is against such an initiative.

- RPAs are a money purchase plan, whereas most occupational plans are of the defined benefit variety. As the appendix to this chapter argues, it is not obvious that the former are more risky than the latter.

Chapter 13: Inflation protection

- Inflation can erode dramatically the real value of pensions.

- However, the lack of inflation protection in most pension plans need not imply that recipients have no inflation protection. Pensioners may be able to hedge against inflation in the context of their overall retirement portfolios and at a lesser cost given the present poorly developed markets for real-term annuities. Compared with an equal-nominal payment annuity, an indexed annuity would have lower initial nominal payments and, depending on the inflation rate, higher later nominal payments. This being the case, a pensioner could do his own indexing by investing the initial payment excess in securities that tend to keep pace with inflation (e.g., CSBs).

- The non-indexation of pensions, combined with inadequate survivor benefits, has probably contributed to the high incidence of poverty among elderly women.

- The fact that income support levels of the public pension system are indexed for inflation provides an incentive for individuals to draw equal-nominal-term pensions. Higher initial consumption is supplemented in later life by the indexed public system as the real value of the pension payments falls. Under an inflation-proof system, some of these pensioners might never be eligible for GIS, for example.

- An argument can be made that pensioners under equal-nominal-payment plans have a right to any excess nominal earnings arising from unexpectedly high rates of interest and inflation. This is a variant of the excess interest approach to inflation protection.

- Money purchase plans provide more flexibility than defined benefit plans in terms of enabling pensioners to cope with inflation.

- The Green Paper's specific proposal for excess interest is woefully inadequate. The variant proposed in the present chapter is much preferable.

- Excess interest annuities should not be compulsory. At the very least, pensioners should have the right to opt for variable or escalating annuities.

- Under present institutional arrangements, compulsory indexation of all annuities would be very expensive. If this were ever contemplated, and we do not recommend that it should be, considerable lead time would have to be allowed for the development of a full-fledged market in real-term instruments. Indexed government bonds could play an important role in developing such markets.

- Inflation-protection measures should not be retroactive.

- The excess interest approach, desirable as it may be for retired persons, should not be applied to active workers. With full disclosure, any excess earnings of the pension fund can be dealt with in the collective bargaining context.

- Public sector pension plans should be required to provide full costing of their benefits, including provisions for automatic indexing. In addition, pension arrangements should be part of the collective bargaining process.

Chapter 14: Ensuring fairness in employer plans

- Some groups of workers will have better pensions than other, similarly-situated groups of workers. This is no cause for concern if there exist compensating wage differentials.

- Portability of private pensions must be enhanced. As noted in Chapter 12, RPAs would facilitate portability.

- Vesting should occur earlier. Our suggestion is that vesting for workers under 30 take place after five years of service, with vesting after two years for those over 30. The purpose of this measure would be to encourage firms to invest in on-the-job training for their younger employees.

- As we noted in connection with RPAs, the Council suggests that the authorities re-examine the locking-in principle, particularly since the overall thrust of pension reform will increase substantially the degree to which pensions are locked in.

- Full disclosure of an employee's annual pension status is essential. So is full disclosure of various annuity options once an employee nears retirement.

- Steps should be taken to ensure that employees' pensions are secure. Again, RPAs have a role to play here. Plan termination insurance represents one possible option. However, we already have in place other effective mechanisms for protecting workers' pensions such as the Pension Benefit Guarantee Fund in Ontario.

- If death occurs prior to retirement, the surviving spouse should have access to the full value of the contributor's accrued pension.

- When death occurs after retirement, survivor benefits should be mandatory unless they have been waived in writing by employee and spouse.

- Legislation in the various provinces appears to be moving in the direction of mandatory and equal credit splitting of pension rights on marriage breakdown. If this is indeed the case, then it will be necessary for the various provinces to attempt to ensure that their various provisions are reasonably uniform. Provincial pension regulatory legislation may have to incorporate measures to aid the courts in this complex area.

- Classification by sex is currently utilized in most benefit areas - life insurance, car insurance, health insurance, pension benefits. Removing sex as a classification for determining actuarially based benefits will pose substantial problems for the insurance industry.

Consistent with our general approach to the provision of retirement income arrangements, it is essential that flexibility be ensured. If the courts mandate unisex annuity tables, it is important that retirees (in this case mostly men) be able to seek out alternative annuity arrangements, such as managing their own retirement pensions. If legislation or the courts do not require unisex tables, it is still desirable that retirees (in this case mostly women) have the option of managing their own pension portfolios.

- The Council recognizes that the extension of coverage is one of the major goals of pension reform. One alternative is mandatory RPA-led expansion of the private pension system. This would lead to greater coverage than the Council's own proposals for reform. However, it would also lead to some substantial costs for certain groups, such as low-income and mobile workers. On balance, we feel that our package of reform proposals is more appropriate at this time than a compulsory pension expansion.

- If a compulsory expansion is in the cards, however, an RPA-led expansion is preferable to a CPP-led expansion.

Chapter 15: Ensuring fairness in public pension plans

- The Council finds it difficult to assess many of the Green Paper proposals in this area, in large measure because the CPP appears to be moving in the direction of being much more than a pension instrument.

- In principle, we can endorse the idea of CPP credit-splitting. We can also support the provision for splitting CPP entitlements in the case of three years of separation. Likewise, we deem it appropriate that survivors' benefits not terminate on remarriage. On the other side of the ledger, we are opposed to homemakers' pensions.

- Our concern arises in connection with those aspects of the benefit structure that appear to incorporate elements of redistribution as distinct from pension elements. We are concerned that the CPP will move too far in the direction of becoming an instrument of social policy. In our opinion, there exist programs that are better suited to serving this objective.

- The Council recommends that a federal-provincial conference be convened to evaluate the range of possible benefit structures for such items as survivors' pensions and disability pensions and to ensure that these are integrated intelligently within the existing set of social programs, such as the Canada Assistance Plan. Little is accomplished by recommending rather generous survivors' benefits for under-65 spouses only to find out that, for those family units that are forced to fall back on the welfare system, these benefits are fully offset by corresponding reductions in other social assistance payments.

Chapter 16: Pensions, savings and the capital markets

- The impact of pensions, particularly OAS-type pensions, on savings and capital has been the subject of considerable economic literature. The initial view that the public system would substantially reduce savings is now being questioned. What is clear, however, is that pension arrangements affect the channels through which individuals save, which in turn influences how the accumulated pools of savings are invested.

- Even if private savings do fall as a result of a public pension system, in an open economy this need not imply that investment or capital accumulation will correspondingly decline. However, what it does imply is that a decrease in domestic savings will be offset by an inflow in foreign savings.

- Pension funds comprise a large and growing share of savings and capital. As of 1981, the accumulated assets of pension funds amounted to $137 billion. However, the unfunded liabilities of public plans were even larger - $142 billion. This figure excludes the unfunded liabilities of non-contributory pensions such as the OAS.

- The different types of pension funds have dramatically different asset portfolios. For example, the Consolidated Revenue Plans (e.g., federal employee's pension plans) and the CPP have 100 per cent of their (partially funded) assets in non-marketable government bonds. In contrast, the QPP has 83 per cent of its assets in marketable government debt and the remainder in ownership-type assets, whereas employer plans in the private sector have 40 per cent of their assets in equities, 40 per cent in non-government financial instruments, and 20 per cent in marketable government debt.

- Regulations concerning pension fund investment limit equity participation to 30 per cent of the common stock of any firm. This general area of pension dominance and control needs more study, particularly in light of Bill S-31. The Council is of the opinion that private and public sector investment regulations should be on an equal footing. Neither public nor private pension funds should be allowed to have a dominating position in capital markets, nor should they be able to influence significantly the direction of economic decision-making.

- The RPAs, since they are managed by individuals, may serve a role in terms of diffusing the power and influence of the large private sector pension pools.

Chapter 17: Pensions and the current elderly

- Most pension reform proposals evaluated thus far would have their principal impact on future pensioners. This still leaves unresolved the situation of the current elderly.

- The income support shortfalls for the current elderly are not an across-the-board concern. This suggests that the cost-effective solution is likely to be selective rather than universal.

- Under present arrangements, selectivity effectively means GIS.

- However, the overall income support system for the elderly needs rethinking. At the low end of the income scale, pensioners are confronted with 50 per cent and often 100 per cent marginal tax rates. At the higher income levels, they are probably treated too generously: an elderly couple receiving $38,000 of other income (beyond OAS) 'breaks even' with the government, paying no net income taxes.

- The Council recommends that consideration be given to designing a new tax schedule for the elderly, preferably along negative-income-tax lines. One such variant might incorporate universal income support (payable monthly like OAS) with a tax-back rate of, say, 30 or 35 per cent until the recipient merges with the regular taxation system.

- In conjunction with the above point, The Council also recommends that consideration be given to phasing out the special tax exemptions for the elderly. As Tables 21 and 22 indicate, the benefits arising from these tax advantages increase with income.

- The 'fairness' objective of pension reform also suggests that low-income persons ought to have greater access to tax-assisted retirement savings. The Council offers two suggestions in this regard: first, allowing a refundable tax credit in lieu of a tax deduction for contribution to RRSPs; second, allowing a minimum lifetime contribution to tax-assisted saving schemes, such as RRSPs and RPAs, that all persons are entitled to.

- Under a restructured delivery system, many of the problems that beset current reform proposals would not exist. In other words, part of the problem with the current arrangements is that many of the components of the system appear to be directed toward multiple goals, with the result that the system becomes increasingly complex and disincentive-ridden.

- Without some such modifications in the income support delivery system to the elderly, the Council is of the opinion that any additional support to those segments of the elderly currently in need will have to be along GIS lines.

Chapter 18: Financing pensions

- One of the early decisions to be made on the public pension front is whether the rising CPP/QPP benefit payouts are to be met by increased contributions or by having the provinces reduce their indebtedness.

- This decision is made more difficult by the coexistence of the CPP and QPP. Whatever solution is adopted, care must be taken to ensure that there is fair treatment between the two plans. The choice of a solution is further complicated by the fact that both levels of government have a say in the level of contribution rates.

- If contribution rates are raised and the monies thus generated exceed the annual benefit payouts, it is the Council's view that these excess CPP funds should not be turned over to the general revenues of either Ottawa or the provinces. Rather, a separate fund should be constituted, with representatives from both government and the private sector, to oversee the investments. Future generations will already be called upon to pay for more than their fair share of pensions. Investing any excess fund proceeds in assets that earned well below private pension fund earnings (as is the case under the existing CPP arrangements) would only exacerbate the transfer of cost to future generations. This consideration is in addition to our earlier point that it is inappropriate to divert pension surpluses into current fiscal operations.

- Although the age of retirement received little or no attention in the Green Paper, it is one of the pivotal variables in the overall pension equation.

- Raising (or lowering) the age of retirement by one year under current arrangements would mean an annual saving (or cost) of approximately $1 billion 1983 dollars for the public pension system.

- Raising the age of retirement in private plans would also have a dramatic impact on contribution and/or benefit levels. Consider an increase in the retirement age to, say, 67. For the same contribution rates, benefit levels can be increased significantly. This occurs because a) contributions are made over a longer working life, b) fewer people reach the age of retirement, and c) the life expectancy after retirement is reduced by two years.

- A similar set of observations is applicable to the public pension system, among them the observation that a rise in the retirement age would increase the ratio of workers to retirees.

- The Council notes that the age of retirement under the U.S. social security system will gradually increase from 65 to 67 years.

- More generally, a trend in some countries toward raising the age for retirement for public pensions appears to be combined with a desire on the part of some individuals to take advantage of early retirement. This suggests that the overall system should move towards increased flexibility. In spite of the fact that most Canadians are members of defined benefit plans, it seems clear that defined contribution plans (whether the existing money purchase occupational plans or the proposed RPAs) offer the greater degree of flexibility.

- We repeat our disappointment that the issue of the appropriate age for retirement did not assume a larger role in the Green Paper. Its critical role in the overall pension arrangements will not be ignored by future generations of taxpaying Canadians.

PART V: PENSION REFORM

Chapter 19: Pensions and the division of powers

- Remarkably, there has been very little discussion in the pension debate of division of powers with respect to pensions. The implicit assumption by most participants, encouraged by the Green Paper's silence on this issue, is that pensions are a federal matter. This is not the case.

- In regard to private pensions, the provinces have responsibility for establishing standards governing such things as vesting, disclosure, investment, and solvency. The federal government regulates pensions in those sectors under its jurisdiction and in those provinces that have not legislated their own pension standards. The federal government also exerts considerable influence by virtue of the Income Tax Act, which sets guidelines relating to pension deductibility and the eligibility of investments for tax deferral. Thus responsibility for private pensions is shared between the federal government and the provinces.

- Responsibility for the CPP is also shared. Any amendments to the plan must be approved by two-thirds of the provinces with two-thirds of the population. The latter aspect of this arrangement gives Ontario a veto on all CPP amendments. In the final analysis, however, the CPP is a provincial plan, since the provinces have the option of following Quebec's lead and taking over the operations of the plan. This essential feature of the CPP is effectively missing from the Green Paper.

- RPAs are an intriguing pension device in the constitutional sense. Like RRSPs, RPAs may fall in the federal domain to the extent that they draw their constitutional existence derives from the Income Tax Act.

- Non-contributory plans such as OAS and GIS appear to fall under federal jurisdiction. Likewise, provincial programs such as GAINS fall under provincial responsibility.

Chapter 20: Implications for Ontario

- Constitutionally, Ontario has a role, perhaps a leadership role, in virtually every aspect of pension reform.

- The Council cannot speak for the Province of Ontario. However, to the extent that Ontario agrees with the thrust of our document, the province should give serious consideration to the implications that flow from it.

- With respect to private pensions, Ontario will have to modify its regulatory environment to accommodate the recommendations relating to vesting, disclosure, inflation protection, and the like. What is even more important, Ontario and other provinces must strive to ensure that there is far greater pension portability in the system so that labour markets become truly national in scope.

- If RPAs are introduced, Ontario will have to take an active role in ensuring that the new pension instrument lives up to its potential. This would mean working with the federal government to ensure that

RPA holders had maximum opportunity to acquire an ownership stake in the economy, to encourage competition on the supply side of the RPA market, and to ensure that RPAs could be integrated and/or co-exist with existing occupational plans.

- With respect to the CPP, we encourage the Province of Ontario to take the lead in ensuring that any future CPP cash flow is invested in financial instruments that maximize rates of return.

- With respect to GAINS, it is clear that the province can improve this program. There is scope here for Ontario and the other provinces to work together with the federal government in redesigning the income support system for the elderly.

- Ontario should consider full disclosure of all aspects of Ontario public sector pension plans.

- Finally, since the federal-provincial financial implications of pensions, particularly the CPP/QPP, have become so significant, the Council recommends that pension reform become an integral component of the quinquennial review of federal-provincial fiscal arrangements.

PART VI: CONCLUSIONS

Chapter 21: Conclusions (no summary observations)

Part II
Pensions: The Status Quo

2
The Status Quo: An Overview

In general, pensions are arrangements, contractual or implicit, designed to provide income in retirement. This definition is not exhaustive, since pension arrangements often incorporate provisions for the payment of benefits prior to retirement (such benefits include disability pensions, survivors' pensions, and death benefits). However, the survey of existing arrangements undertaken in the following chapters will focus primarily on retirement benefits.

It is important to begin the analysis by spelling out the differences in principle and in practice between private and public pension plans. In their purest form, private pensions are contractual arrangements, whereas public pensions are non-contractual. In addition, private pensions tend to be actuarially funded, while public pensions tend to be intergenerational transfers. In practice, this distinction can become blurred, since private pensions often involve some element of intergenerational transfer, and public pensions can embody contractual relationships.

Table 1 provides an overview of most of the programs that constitute the Canadian pension system. It outlines the differences between private and public pension plans and also addresses basic questions relevant to both types of plans:

a) Who pays, or who contributes?
b) Who benefits?
c) How are these benefits determined?
d) What is the nature of the contractual arrangement (if any)?
e) Who is the sponsor (administrator) of the plan, and who controls the investment decisions of the fund (if one exists)?

TABLE 1 An Overview of existing pension arrangements

	Who contributes?	Who benefits?	How are benefits determined?
1. Occupational Plans:			
A. Defined Benefit	• both employers and employees in contributory plans, only employers in non-contributory plans	• retiring employees who were with the firm long enough to be vested • surviving spouses in plans with survivor benefits	• specified formula (e.g., final-average earnings, career average, flat benefit plans)
B. Money Purchase	• both employers and employees	• same as above	• function of past contributions plus accumulated earnings • pensioner can select various types of annuities
2. RRSPs	• individuals contribute to own or spousal plans • contributions are tax deductible up to a limit	• individuals can withdraw funds from plans before or after retirement	• same as money purchase plans
3. Old Age Security (OAS)	• federal government, out of general revenues	• all Canadians aged 65+	• flat benefits, fixed by federal legislation • indexed quarterly to CPI
4. Guaranteed Income Supplement (GIS)	• federal government, out of general revenues	• low-income residents aged 65+	• maximum benefits fixed by federal legislation • benefits differentiated between single and married units • income tested (50% tax back) • indexed to CPI
5. GAINS[a]	• Ontario government, out of general revenues	• Ontario residents aged 65+ with low incomes	• maximum benefit fixed by provincial legislation • benefits differentiated by single and married units, latter are indexed • income tested (50% tax back)
6. Elderly Tax Exemptions[b]	• federal and provincial governments, out of general revenues	• Canadians, aged 65+, with income high enough to be tax payers	• benefit depends on caimant's marginal tax rate; higher marginal rate, larger benefits • exemptions are indexed
7. CPP/QPP	• employers and employees pay special CPP/QPP contributions • current rate is 3.6%, evenly split	• those 65+, or disabled, who have paid sufficient CPP/QPP premiums • surviving spouses of CPP/QPP contributors	• specified benefit formula, determined more by earnings than contributions • indexed quarterly

[a] Guaranteed Annual Income System. This program operates only in Ontario. Most other provinces have alternative schemes.

[b] This relates to the age exemptions. The $1,000 pension exemption would be characterized similarly, although it is not indexed. The various provincial tax credits for the elderly are excluded from the table, as are such things as free health care, etc.

Nature of the contractual agreement	Who administers and controls the plan?	Other characteristics
• explicit contract between employers and employees, often part of overall compensation package	• generally the employer • some public sector plans tend not to be funded in the actuarial sense[e]	• benefits basically are a function of earnings profile, not contributions
• same as above	• generally the employer, although often an employee has some say over how his/her funds are invested	• benefits basically determined by contributions and fund performance, not by earnings profile
• between RRSP-owner and financial institution holding the fund; otherwise self-administered	• individual or institution, although inflow of new funds is controlled by individual	• same as money purchase plans • maximum contribution rates have not been indexed
• no formal contractual relationship • strong implicit or social contract	• no plan or fund	• basically an inter-generational transfer • universal program, not dependent on work experience
• same as above	• same as above	• CPP/QPP benefits are viewed as part of income in terms of being subject to the 50% tax back
• same as above	• same as above	• 50% tax-back rate • GAINS benefits are "stacked" with GIS so that overall tax-back rate is 100%
• none	• same as above	
• no formal contractual arrangement although the public perception is one of contributing to retirement income	• joint federal-provincial plan • surplus CPP contributions invested in provincial securities • QPP also invests in private assets	• until fund matures, current contributors receive a substantial subsidy relative to future contributors

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[e] **A better distinction between public sector pension funds is whether they fall under the category of trusteed funds and, therefore, are similar to private sector funds or whether they are consolidated revenue funds, which are not 'funded'. For Ontario, the former would include the teachers' superannuation funds and OMERS (Ontario Municipal Employees Retirement System). These are essentially funded plans.**

In effect, Table 1 both introduces and summarizes the discussion in Chapters 3, 4 and 5 of private pensions, public pensions, and Registered Retirement Savings Plans (RRSPs), respectively. The remaining chapters in Part II complete our description and evaluation of the present Canadian pension system. Chapter 6 directs attention to the financing problems associated with the public pension system. Chapters 7 and 8 deal with another concern in the pension debate, namely the adequacy of pensions for the elderly. Chapter 7 addresses this topic in terms of income support, Chapter 8 in terms of income replacement.

3
Private Pension Plans

The characteristics of the system

Private pension plans, frequently referred to as occupational pension plans, are contractual arrangements under which an employee and his employer jointly set money aside during the employee's working life so that he can be provided for in retirement. There are basically two principal forms of private pensions: defined contribution plans and defined benefits plans.

Defined contribution plans, frequently referred to as money purchase plans, specify the annual contributions of the employee and employer. They do not define the benefits. The benefits are determined by the amounts contributed and by the investment performance of the pension fund.

In defined benefit plans, each year of contributions normally entitles the employee to one unit of benefit. There are several ways in which these years of service, or units of benefit, can be related to the pension entitlement. They include:

a) final average (or final earnings) plans, which apply the unit of benefit credited for each year to the member's average earnings for a specified number of years, say five, just before retirement.
b) best earnings plans, which apply the unit of benefit credited for each year to the member's average earnings for a specified period of highest earnings, e.g., the highest five of the last ten years of earnings.
c) career average plans, which apply the unit of benefit credited each year to the member's earnings in that year.

d) flat benefit plans, which specify a dollar amount of pension to be credited for each year of service.

A significant feature of all pension arrangements (public and private) is that the contributions (both employee and employer) are treated as a deduction for income tax purposes. Moreover, any accretions to the value of the contributions, whether they arise from the investment returns under a money-purchase plan or from the crediting of entitlements under a defined benefit plan, are subject to tax only on retirement and then only as they are received as benefits. In addition, there are normally some restrictions relating to the manner in which these benefits can be paid out on retirement.

Some data on occupational plans

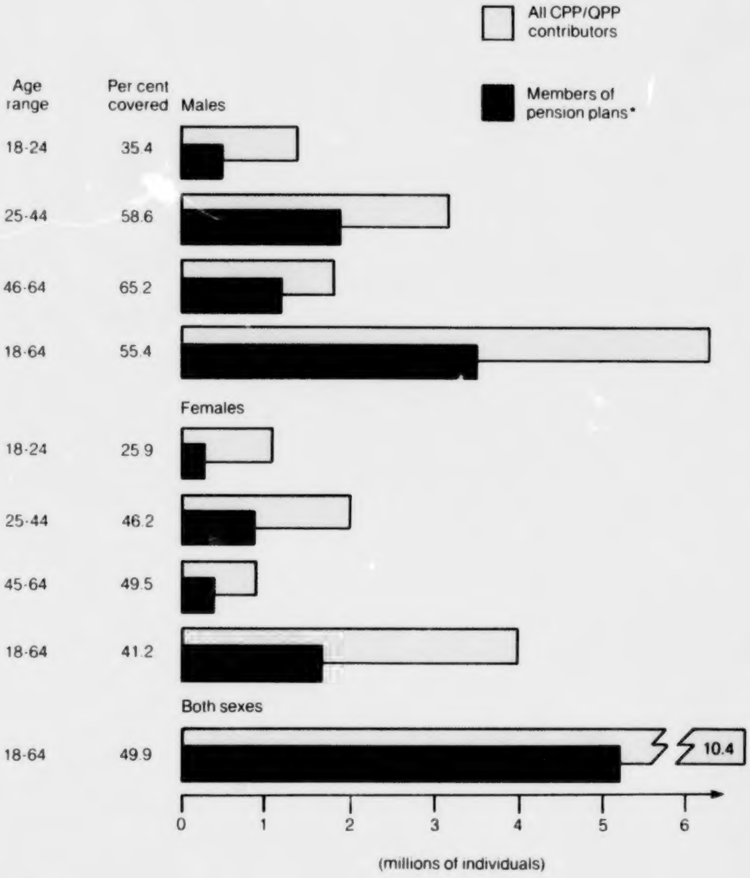
Table 2, reproduced from the Green Paper, details private pension coverage by age group. Overall, 55 per cent of male contributors to the CPP are also members of private pension plans, as are 41.2 per cent of female contributors. Not surprisingly, therefore, the issue of private plan coverage looms large in the pension debate. It should be pointed out, however, that the information in Table 2 is somewhat misleading, since the figures do not take income class into account. Later in the document we shall present some new data on occupational plan coverage, cross-classified by age, income, and the sector (public or private) in which the plan operates.

Table 3, again adapted from the Green Paper, presents data on the composition of the private pension system. While there are more money purchase plans than there are defined benefit plans of any one type, defined benefit plans of all types dominate the private sector in terms of both numbers of plans and numbers of members. Moreover, the overwhelming proportion of public sector employees belong to defined benefit plans.

Definitions

At this juncture, several further concepts need to be introduced. Contributions to a pension are said to be locked in if they cannot be withdrawn after a certain date. Normally, locking-in occurs once an employee has

Table 2
Pension plan coverage in 1979 by sex and age (millions of individuals)



*CPP/QPP contributors who were also members of employer-sponsored pension plans and/or RRSP contributors.

SOURCE: Canada (1982), *Better Pensions for Canadians* (Ottawa) p. 20.

TABLE 3
The composition of the private pension system: 1980[1]

	Private sector plans					Public sector plans	
				Final or best average			
	Money purchase[2]	Flat benefit	Career average	Contrib.	Non-contrib.	Not fully indexed	Fully indexed
Number of plans	5,887	1,243	4,299	1,132	944	661	29
Members (thousands)	211.5	956.6	545.4	424.8	311.2	1,028.9	941.0
Members (as a percentage of all plan members)	4.7	21.4	12.2	9.5	7.0	23.0	21.0
Typical unit benefit rate	n/a	$12.50	1.80%	1.85%	1.41%	2.00%	2.00%
Nominal employee contribution rate[3]	5.0	nil	5.0	5.0	nil	6.4	7.5
Average employee contribution rate[4]	3.9	nil	3.9	3.9	nil	5.3	6.4

[1] Not included are 391 composite, level percentage of earnings, and other types of plans covering 56,000 employees (1.2 per cent of all plan members).

[2] Includes 283 public sector money purchase pension plans covering 19,800 employees in the group of not fully indexed public sector plans. Most money purchase plans involve employer contributions that match employee contributions.

[3] As a percentage of pay, ignoring integration with the CPP/QPP.

[4] As a percentage of pay, after adjusting for CPP/QPP integration.

SOURCE: Canada (1982) Better Pensions for Canadians (Ottawa) p. 60.

attained a certain age or completed a certain period of service. A pension is said to be vested if on termination of employment an employee has a right to his accrued pension. Normally, the employee acquires the right to the employer's past contributions as well. Typically, vesting is associated with locking-in. Thus, vested benefits usually take the form of a deferred annuity commencing at retirement age. Statutory vesting occurs when the employee meets the age and/or service conditions set out in the pension benefits legislation (in Ontario, currently age 45 and 10 years service). A pension is said to be portable when an individual, on severing employment, can take the pension with him to his new employment or convert it into an RRSP.

Many combinations are possible. If an individual leaves his employment prior to full vesting or locking-in, he typically has the right to withdraw previous contributions, often with accumulated interest. He can then transfer these funds to an RRSP or cash them in. In the latter case, they would be treated as income for tax purposes. A pension may be vested but not locked in, in which case the employee may also have some claim on the employer's contributions on his behalf. If a worker leaves his firm before his contributions are vested, he may lose the entire amount in his pension account. Generally, there is more portability across public sector pension plans than there is across private sector plans.

It is not surprising, perhaps, that one of the major thrusts of pension reform is for earlier vesting, earlier locking-in, greater coverage, and enhanced portability. A comparison of eight industrial countries suggests that 'the membership coverage of employer-sponsored pension plans in Canada is on the low side compared with the other seven industrial countries. Compulsory vesting under private plans in Canada is required later than in all of those seven countries. Locking-in of employee contributions is also later in Canada than it is in the five countries which also require it.'[1]

There is little question that reform in these areas would enhance the ability of member workers to provide for their retirement income. What is not so clear, however, is whether or not such reform would increase workers' lifetime incomes. As we shall discuss below, it is possible that it would decrease workers' lifetime incomes. In this connection, it is important to recognize that the Green Paper appears to assume that the costs of pension reform would likely be borne by the employer and not the employee. In fact, the opposite is far more likely to be the case. In order to address this important issue it is necessary to consider why private pensions exist in the first place.

Why do occupational plans exist?

Economic analysis typically focuses on two major reasons why private pensions exist. The first is that pensions represent a tax-favoured vehicle for savings. If an employee faces a constant marginal tax rate over his lifetime, then the tax deferral properties of registered pension plans enable him to earn the pre-tax rate of return on savings. If his marginal tax bracket is likely to be lower in retirement, he has an even greater incentive to save through a registered pension plan. Although both occupational plans and individual RRSP arrangements offer these incentives, the lower management costs per person of pension plans that cover large numbers of employees are likely to make them more attractive than self-administered retirement savings arrangements: hence the rationale for employer-sponsored plans.

The second reason why firms provide pension plans (and why most private plans are defined benefit plans) is that these plans play a central role in incentive-oriented long-term labour contracts. For example, delayed vesting provisions may facilitate investment by firms in workers' training and skills. If an employee leaves the firm prior to vesting, the firm obviously loses the time and money that have been invested in the worker. However, the departing worker cannot take his 'deferred wages' with him, since they have not been vested. It is clearly in the firm's interest to induce workers to remain long enough for the firm to recoup its investment costs. Here is where defined benefit plans play a key role - the best earnings or final average versions of such plans embody an accrual of pension rights that normally rises sharply with long-term service. As Alan Blinder has remarked:

> Every worker represents (human) capital owned by the firm; if he quits, he destroys some of the firm's capital. Firms will therefore have an incentive to draw up a compensation scheme that reduces mobility, and pensions are a convenient way of doing this.[2]

Consider the reform proposal that vesting (the time at which an employee becomes legally entitled to a benefit under the terms of the plan) occur after two years of service. The proposal is motivated by the fact that, at present, a mobile employee may forfeit his 'deferred wages' if he fails to meet the age and/or service requirements of existing vesting rules. However, if delayed vesting is outlawed, firms may be forced to adopt alternative devices in order to reduce labour mobility and retain valued workers. Steeper wage grids with respect to years of service (lower wages initially, higher wages later) would serve this purpose, imposing equivalent costs on the mobile worker. Further, deferred vesting may allow the employer to assume the initial cost of upgrading the general (or transferable) skills of the workers. In its absence, the worker may be forced to assume these costs, in the form of lower starting wages, and the net result could be a reduction in investment in human capital.

In raising these issues, we are not suggesting that private plans as they currently exist are adequate. Indeed, as we shall show later, some reform is necessary. However, it is important to recognize why these private plans exist and what purposes they are designed to serve. Outlawing those features of pension contracts that form part of the incentive-oriented compensation package would in all likelihood encourage firms to introduce substitute incentive arrangements. Thus, while it is likely that initiatives to expedite vesting and to enhance portability would improve the delivery of retirement incomes to mobile workers, it is less likely that they would increase lifetime incomes at least for some groups of workers. In other words, pension reform would likely have its costs. It is important that reform advocates recognize this and, if possible, anticipate the nature of any offsetting changes in private sector compensation arrangements.

Who really pays for pensions?

There is a related issue that deserves more attention than it has thus far attracted. As noted above, the discussion of pension reform appears to contain an implicit assumption that workers would emerge from the reform process as the clear winners. Yet economic analysis suggests that it would be the workers who would bear the cost of improved pension benefits, via reduced current wages or reductions in other parts of the total compensation package. Moreover, our background research suggests that the incidence of these costs would vary substantially across the various categories of workers. For instance, Charles Beach's paper in our background volume suggests that increases in the CPP contribution rates would result in much larger reductions in take-home pay for prime-age male workers than for older female workers. Such differences in the effects on different types of workers might also result from mandated changes in private pension arrangements. Recent research from Laval University[3] on the impact of payroll taxes on employment (see Rousseau and Taurand 1983) indicates that a 1 percentage point increase in payroll taxes would, in the long run, cost 5,000 jobs in Quebec. Were these results to hold for all of Canada, a 1 percentage point increase in payroll taxes would result in the loss of some 20,000 jobs. Again, the point is that pension reform could involve substantial costs - costs not only in terms of reduced present income, but also in terms of reduced employment opportunities. In short, improved prospects for retirement income would be bought at the expense of reduced prospects for current income.

The view that pension benefits are deferred wages, and thus part of a total compensation package, is now generally accepted by economists. If a firm voluntarily enriches a pension benefit formula, one may infer that (net of any productivity-enhancing incentive effects) the firm has received an equal concession in terms of reduced current wages or a reduction in some other part of the compensation package. If such enrichments were imposed by legislation (and apply only to future service), it is possible that firms would bear a portion of the cost in the short run. However, the ultimate incidence of the cost of the enriched benefits would likely be borne by workers, who would either suffer reduced compensation elsewhere in the overall package or, in their role as consumers, face higher prices. If these alternatives were not available, firms would likely terminate their pension plans. Blanket statements with respect to this issue are not possible, since some firms may view pension arrangements as part of their corporate 'social responsibility', as it were.

If, however, the enrichments imposed by legislation were retroactive and applied to past service, then the costs would likely be borne by the shareholders of the firm. If a benefit were due a worker whether he remained with the firm or not, which would be true of retroactive enrichments imposed by legislation, then the firm would not be able to extract wage concessions in return for the enrichment. If the firm sought to do so, the worker would have an incentive to quit and find employment with a firm that would pay him total compensation equal to the current value of his labour services. As a matter of principle, however, the Council is opposed to retroactive reform measures that affect existing contractual arrangements.

Perceived problems with private pensions

With this discussion as a backdrop, it is now useful to examine those characteristics of private pensions that have generated concern. While the Council does not necessarily endorse the Green Paper's identification of the problems that beset the private pension sector, it seems appropriate, for present and later purposes, to reproduce verbatim the Green Paper's concerns:

> There have been significant improvements in employer-sponsored plans over the last 15 years. Indeed, many plan sponsors exceed the minimum standards now set by government regulation. Nevertheless, three shortcomings stand out.
>
> First, Canadians entitled to pensions are finding the value of these pensions eroded by inflation. Few plans provide automatic cost-of-living increases, though many employers make ad hoc increases from time to time which partially offset inflation. In recent years many employer-sponsored plans have earned relatively high returns on pension fund investments as a result of inflation. These relatively high returns were not anticipated in the actuarial valuation of the plan and would normally have resulted in surpluses accumulated within the plan. An appropriate response would have been to apply at least part of these higher returns to the provision of inflation protection for benefits - both those already earned by active plan members and, particularly in the case of returns on pension funds held on behalf of retired plan members, to pensioners. To a large extent, however, these higher returns have been used for other purposes - to increase the size of unit benefits for active as opposed to retired plan members, or to lower employer contributions to pension plans.
>
> Second, belonging to an employer-sponsored plan does not necessarily mean that an employee will ultimately receive a pension. Employees often lose pension rights if they change employers or if they leave their jobs before retirement. Their own contributions may be returned, but often with interest at a rate substantially below what could have been earned elsewhere. They also forfeit some or all of the benefits based on contributions made on their behalf by the employer. If they belonged to a pension plan where the employer made all the contributions, they may receive nothing at all. This problem is particularly serious because of Canada's high labour mobility, a mobility that not only serves Canadians individually but is vital to a healthy economy.
>
> Finally, pension problems are worse for women. Women are often in jobs where they are less likely to be offered pension plan coverage. Women who are covered by pension plans are more likely to lose any pension benefits they may have accumulated because they change employers more frequently than men. Many pension plans do not provide adequate survivor benefits and few married women benefit from the pension credits of their spouses upon marriage breakdown. As the cumulative result of such shortcomings, many women spend at least some of their retirement years with insufficient income. (pp. 12-13)

The role of the provinces

As a final comment on private pension reform, it is necessary to bring to light another misperception, namely that pensions are a federal matter and that pension reform is up to Ottawa. Like the assumption that the costs of pension reform would be borne by employers, this misperception is implicit in the Green Paper. As a matter of fact, however, it is the provincial governments that have the principal responsibility for regulating occupational plans. In general, these plans are registered in the province where the majority of plan members reside. The governments of Ontario, Quebec, Nova Scotia, Alberta, Saskatchewan, and Manitoba have enacted legislation setting minimum standards for the plans registered in their provinces. New Brunswick and British Columbia have recently indicated that they will introduce similar legislation. While the provinces have made important steps in the direction of harmonizing their regulations, much more could and, as we shall suggest later, should be done. The provinces also have an important stake in the RRSP provisions (RRSPs will be the subject of Chapter 5). Even though these provisions were introduced into the personal income tax (PIT) system by the federal government, the fact that the PIT is a shared tax system (for the nine provinces that are signatories to the tax collection agreements), with roughly one-third of PIT revenue accruing to the provinces, means that the provinces are involved in this aspect of overall pension arrangements as well.

In general, our approach in most of the analysis that follows is to side-step the issue of who is responsible for pension reform. However, we focus in detail on this issue in Part V of the document.

Trusteed plans vs. Consolidated Revenue Plans

We began this chapter by suggesting that one characteristic of occupational plans is that they are fully funded. This description applies to trusteed pension plans, defined as those plans that convert contributions and earnings into invested assets and that meet pension obligations and other costs out of these funds. The trustee (which may be a group of three or more persons, a trust company, or a pension fund society) is responsible for holding the funds, prudently investing them, and ensuring that all relevant regulations are complied with. Many public sector pension plans are of this nature, particularly those of employees of crown corporations, health and educational institutions, and provincial and municipal agencies. The Ontario Municipal Employees' Retirement System (OMERS) falls in this category. However, not all public sector plans are trusteed plans. In particular, the so-called Consolidated Revenue Plans, which cover most federal government plans, are not trusteed plans. As Table 20, below, indicates, such plans are not fully funded. Indeed, as of 1981, it is estimated that these plans are unfunded (that is, they have claims on future generations) to the tune of $12 billion.

The Business Committee on Pension Policy (BCPP) makes the following comments in this regard:

> The Auditor General of Canada has quoted that there is an unfunded liability for the PSSA [Public Service Superannuation Act] and related portion of SRBA [Supplementary Retirement Benefits Act] of $7.6 billion at March 31, 1982 for this group of federal government employees. The BCPP Cost Study estimated that amortization of this unfunded liability over 15 years would require additional annual employer contributions representing 11.3 per cent of the 1982 federal public service payroll.[4]

The current employee contribution rate into these plans is 6.4 per cent. If all the additional cost were to be borne by the federal government, its contribution rate would have to rise to near 21 per cent.[5]

This state of affairs has several implications for private sector pension reform, implications that will be highlighted later in the document. For present purposes, it is sufficient to emphasize that it is all too easy to focus on such public sector plans as 'ideal' plans, particularly with respect to inflation indexing, without recognizing the 'full cost' of the benefits they incorporate.

Conclusion

The purpose of this brief overview of the private pension system and some of its characteristics has been to provide the background needed for the later discussion of reform proposals. In any such discussion, it is important to understand what motivates the private pension system and what one can reasonably expect it to do and not to do in response to various reforms. We now turn to a similar overview of the public pension system.

Private Pension Plans: Council Summary Observations

- Approximately one-half of working Canadians are members of occupational pension plans. Most of these workers belong to defined benefit plans of one kind or another, rather than to money purchase plans. The coverage rate is too low, and some reform is warranted on coverage grounds. We shall have much more to say on this issue in later chapters.

- It is important to recognize that pension plans are an integral part of incentive-oriented, long-term labour contracts. In particular, they typically play an important role in facilitating on-the-job training and other investment in workers' human capital.

- Economic analysis suggests that workers will bear the costs of pension reform. While reform measures will enhance the ability of workers to provide for their retirement years, they should be introduced with an eye to minimizing the impact on pre-retirement income and the accumulation of skills.

- Legislation that applied retroactively could saddle employers with some of the costs of pension reform. However, the Council is adamantly opposed to retroactive reform measures.

- Some public sector pension schemes are not fully funded plans but rather consolidated revenue plans. It is inappropriate to use the benefits these plans provide as a standard against which to measure private sector plans unless one also takes into account the actuarial cost of these benefits. Recent estimates suggest the federal government would have to set aside an additional 11.3 per cent of its total payroll over a 15 year amortization period to cover the unfunded liabilities in its pension plans.

4
The Public Pension System

Introduction

In general, the private pension system is geared to the provision of adequate retirement incomes for covered employees. This is frequently referred to as the income replacement goal of the pension system. The public pension system also incorporates this goal, but it adds a further and perhaps more fundamental objective - income support, or the provision of an adequate level of income for elderly persons who, for one reason or another, have not been able to generate sufficient retirement income.

Two observations follow from this. First, the private and public sector pension systems are closely related. To the extent that the private sector improves its provision of replacement income, the public system will probably put increased emphasis on income support. But if the private sector falters in the generation of adequate replacement income, the public system may assign priority to this goal. Second, the pursuit within the public system of both income support and income replacement objectives inevitably leads to some problems, since these goals are often in conflict.

A major part of this chapter is devoted to an elaboration of these points. A second role for the chapter is to describe the various programs that make up the public pension system. Among the components that will be singled out for brief analysis are (1) the Canada (and Quebec) Pension Plan, (2) Old Age Security, commonly referred to as OAS, (3) the Guaranteed Income Supplement (GIS), (4) the various provincial supplementary schemes, such as Ontario's Guaranteed Annual Income System (henceforth referred to as GAINS), and (5) the special age- and pension-related deductions within the personal income tax scheme. Not incorporated in the analysis in this chapter, or in Table 1, is the growing range of tax breaks and subsidies for the elderly. This category of benefits includes such things as free health insurance, free drugs, subsidized housing, sales tax and home heating grants under the income tax system, and the various 'breaks' for the elderly with respect to airline and theatre tickets, bank clubs, restaurant meals, etc. Some of these benefits, such as free drugs, are worth a considerable amount, while others are relatively trifling. In the aggregate, however, they amount to a further substantial transfer of income to the elderly.

Pure pension vs. pure redistribution

In the introduction to Part II, we noted that public pensions, in contrast to private pensions, tend to be non-contractual and therefore characterized by intergenerational transfers, or transfers from the current workers to current retirees. It is convenient to elaborate on this by focusing on two broad rationales that can be viewed as underlying the discussion of public pensions - the 'pure pension' approach and the 'pure redistribution' approach.

If the public pension system took a pure pension approach, it would be contractual and actuarially funded, like existing private sector plans. It might also be universal, with full portability and immediate vesting. The important point is that the pure pension approach does not characterize any existing public pension programs. The CPP/QPP comes closest, but, as will be emphasized later, it is neither contractual nor funded in the actuarial sense of the term. Nonetheless, discussion of the possibility of an expansion of the CPP in order to enhance income replacement will be an important part of the analysis of public sector pensions.

There is a second way to view public pensions, namely the pure redistribution approach. According to this view, public pensions should be evaluated in light of the wider objective of the public sector to redistribute income from the rich to the poor through a system of progressive taxes and transfers. Hence, public pensions are merely one part of a wider social safety net. In fact, a pure redistribution system would probably not be universal but would instead provide transfers only to the elderly poor. Moreover, because of the stress on redistribution, pension benefits and contributions made during working life would not have to be linked. Transfers to the elderly, like most other transfers made by government, could be financed by taxes. Contributions to a public pension system are, in this interpretation, no different from a tax, whatever they may be called. In this view, in fact, 'pensions' is a misnomer, since what operates is a tax-transfer system akin to other elements of our tax-transfer system, such as welfare, unemployment insurance, and the like.

In much of the discussion of the role of the public sector in pension reform, the intention is to accommodate both these goals, often with the result that the real issues become clouded. Consider, for example, the argument that the CPP should be altered to provide benefits for elderly females, since, as will be demonstrated later, this is the group among the elderly that finds itself in the most dire straits. On 'pure pension' grounds this argument is weak, since generally these persons have made no retirement contributions during their working lives. However, in terms of the 'pure redistribution' view, the argument is sound because this group is deserving of income support. In the description and evaluation of the five components of the public pension system that follows, these two approaches should be kept in mind, along with the characteristics highlighted in Table 1.

The components of the public system

Old Age Security (OAS)

Contrary to popular opinion, OAS and not CPP is the bulwark of the public pension system. As Table 4 indicates, in 1982 OAS accounted for roughly $6 billion out of total federal support to the elderly of $11 billion. Benefits under OAS are universal, i.e., they go to all persons 65 years of age and older. (This is not quite true: residency requirements introduced in 1977 exclude many immigrants from full OAS benefits.) As of April 1983, the monthly benefit level was $254.13 per person, for a yearly total of $3,049. OAS benefits are normally indexed fully to the CPI, but at present the provisions of '6 and 5' apply.

Old age security benefits are financed on a pay-go basis. In this sense they amount essentially to intergenerational transfers, and even though they are universal, rather than targeted to the most needy, they are consistent with the pure redistribution rather than the pure pension function. The fact that OAS benefits are taxable should, in principle, increase the ability of OAS to target benefits. However, because the decision to make OAS benefits taxable coincided roughly with the granting of special income-tax deductions for the elderly (to be detailed below), the

TABLE 4
Federally funded income support programs for the elderly

	Expenditure $bill. 1982	Number of recipients as of March 1983 (in millions)	Maximum yearly benefit as of April 1983 ($)	Average yearly benefit	Average monthly benefit as of March 1983
1. Old Age Security (OAS)	6.14	2.42	3049	3049	254
2. Guaranteed Income	2.24	1.25	single - 3061	1888[b]	157[b]
Supplement (GIS)			married - 2360 ea.		
3. Canada Pension Plan (CPP)	2.45				
Retirement pensions	1.59	.975	4141	2318	193.24
Disability pensions	.280	.108	4049	3173	264.47
Children's benefits	.034	.041	943	942	78.54
Surviving spouse's pension	.402	.312	<65;2996 >65;2485	1728	144.02
Orphan's benefits	.084	.101	943	942	78.52
Death benefits	.055	.050[c]	[1850][d]		
4. Spouse's Allowance	.203	.087	5409	2510[b]	209.21[b]
5. Quebec Pension Plan[a]	.881[c]				
Retirement pensions	.446	.278	4141	2361	196.81
Disability pensions	.105	.028	5523	4725	393.81
Children's benefits	.004	.101	348	348	29
Surviving spouse's pension	.219	.118	<65;3970 >65;2485	2592	216.01
Orphan's benefits	.015	.041	348	348	29
Death benefits	.019	.159[3]	[1850][d]		

[a] This is not a federal program, but has been included since it replaces CPP in Quebec.
[b] Data per recipient for 1982.
[c] 1981.
[d] This is not an annual benefit. It is a one-time lump-sum benefit.
SOURCE: Whalley and Hamilton.

net effect has been to offset the impact of subjecting OAS to tax.

GIS

The Guaranteed Income Supplement (GIS) provides extra income beyond OAS for those over 65 with limited sources of income. GIS payments are income-tested (not means-tested) and are generally reduced by 50 cents for each dollar of non-OAS income. (This includes CPP income as well as market income.) As of April 1983, the maximum monthly benefit for a single pensioner was $255.13, for a yearly total of $3,061, as indicated in Table 4. For married pensioners, the maximum monthly benefit was $196.70 each, for an annual family total of $4,721. The average benefit per recipient in 1982 was $1,888, and total GIS payments amounted to $2¼ billion. Note that this total is roughly equal to the flows arising from CPP. Since, for a single pensioner, it takes $6,122 of outside income (i.e., twice the $3,061 maximum payment) before GIS entitlements fall to zero, individuals receiving the maximum CPP benefit may still receive partial GIS payments. For a married couple the comparable figure is $9,442 (twice the $4,721 maximum payment) before GIS entitlements fall to zero. Thus, even though GIS is likely to become somewhat less important relative to CPP as the latter plan matures, it will still be a significant feature of the overall public pension system. This is especially true because GIS is the epitome of a 'pure redistribution' approach to pensions. It goes to those who need it most, unlike OAS or CPP.

GAINS

The governments of Ontario, Nova Scotia, and the four western provinces provide additional income supplements to elderly residents of their provinces. Rather than list the programs in all of these provinces, we shall describe in detail only the benefits provided by the government of Ontario.

Ontario's Guaranteed Annual Income System (GAINS) supplements the federal OAS and GIS programs. In 1983 the maximum monthly supplement for single pensioners is $48.88. For a married couple, the supplement for each person is $79.81. GAINS, like GIS, is income-tested, with a tax-back rate of 50 per cent against income from other sources. To anticipate the later analysis of GAINS, there are two problems associated with this

Ontario supplementary scheme. The first relates to the fact that under the federal programs couples fare much better than single individuals, in the sense that the support they receive bears a closer relation to the various 'poverty' lines. Peculiarly enough, the benefit schedule under GAINS *magnifies* this discrepancy. Indeed, while GAINS supplements for married couples are indexed quarterly to reflect increases in the CPI, supplements for single persons are adjusted for inflation on an *ad hoc* basis, and no adjustment has been made since 1980. Second, the income-testing associated with GAINS is simply *stacked on top of the income-testing of GIS*. This means that the marginal tax-back rate on outside income is *100 per cent* until the benefits under GAINS run out. This arrangement has substantial implications for many aspects of the overall public pension system, not the least of which is that it represents a severe disincentive for low income workers to set aside any private pensions or savings for retirement. However, despite these high tax-back rates, it is important not to lose sight of the fact that GAINS does target its benefits very effectively - they do go to those who are in most need.

Additional benefits are provided by the Ontario Tax Grants for Senior Citizens. The Ontario Property Tax Grant provides up to $500 per year to each Ontario household headed by a senior citizen. This benefit is reduced only if homeowners' annual property tax payments are less than $500 or tenants' annual rent payments are less than $2,500. Each recipient of the Property Tax Grant also receives the $20 Temporary Home Heating Grant. Every Ontario senior citizen is eligible for the $50 Ontario Sales Tax Grant. Ontario Tax Grants for senior citizens are non-taxable and are distributed to all eligible recipients regardless of income.

Provincial governments also provide subsidized rental accommodation for senior citizens. The Ontario Housing Corporation, an agency of the Ontario government, provides subsidized rental housing to Ontario residents aged 60 and over. Accommodation is allocated on the basis of a point-rating system that is designed to measure the need of an applicant for assistance. Rent charges for OHC accommodation are limited to 25 per cent of a household's gross income (including transfer payments). The latest estimate is that approximately 50,000 OHC rental units are occupied by senior citizens.

Because GAINS is a provincial program designed to top up the income levels of the elderly, it attracts more attention in the pension debate than the other Ontario programs. However, it is *not* the most significant program in terms of the dollars involved. In 1981-82, Ontario spent nearly $300 million on Ontario Tax Grants, compared with just under $100 million under GAINS. There was, of course, considerable additional expenditure for subsidized housing, free drugs, medicare, and other benefits.

Age and pension tax exemptions

Present taxation regulations allow an additional personal deduction of $2,360 for all persons aged 65 and over (the age exemption). This deduction is indexed to the CPI (although indexation for 1983 and 1984 has been limited to '6 and 5'). Furthermore, the first $1,000 of pension income (apart from CPP/QPP) is deductible for tax purposes. Thus, the overall additional deductions amount to $3,360 for single people and $6,720 for couples, assuming that each individual is in receipt of at least $1,000 in pension income. Several observations are appropriate:

- These tax measures are very regressive - the benefits are higher for those with higher incomes. For a person with no income beyond OAS and GIS, the value of the extra exemptions is zero, whereas for a person in the 50 per cent tax bracket the extra deductions are worth $1,680, and double this for a couple.

- There may be many ways to justify such exemptions, but it is clear that they do not serve the 'income support' role of delivering money to those persons or families that need it the most. Indeed, for com-parison purposes, it is appropriate to recall that the benefits of GIS are highest for those individuals and families that need them the most. On the other hand, the maximum benefits from these additional deductions accrue to those individuals and couples who need them the least.

- Since the OAS level is roughly equal to the age and pension deductions ($3,049 vs. $3,360, respectively), the effect of the deductions is, as noted above, to negate the fact that OAS payments are taxable.

The Canada Pension Plan

The final major components of the public pension system are the Canada and Quebec Pension Plans. The latter plan provides benefits similar to those available under the Canada Pension Plan, but the funds are separately administered by the Province of Quebec. Each is a compulsory, earnings-related, pension plan with a contribution rate of 3.6 per cent, divided equally between employers and employees. The self-employed pay the full 3.6 per cent.

These contribution rates are levied against earnings up to what is known as the Year's Maximum Pensionable Earnings (YMPE). Currently, YMPE is $18,500. It is scheduled to increase by 12.5 per cent each year until it reaches the average industrial composite wage. Since the industrial composite wage is now $20,450, the MPE level should achieve this limit in two or three years.

The formula for calculating CPP benefits, which is quite complex, has been relegated to an appendix to this chapter. For a worker who has full entitlements (i.e., has logged enough years) and has been employed throughout at the YMPE, the maximum pension is one-quarter of the three-year average of YMPE ending with the retirement year. In 1983, the maximum monthly CPP benefit was $345.15, for an annual pension of $4,142. As Table 4 shows, the average CPP benefit in 1982 was $2,318, well below the maximum. There are two reasons why a recipient may receive a less-than-maximum pension. First, the recipient may have earned a wage during his working life that was less than the YMPE. In other words, the pension benefit is based on pensionable earnings. Second, the CPP only began in 1966, and many pensioners did not have an opportunity to log sufficient years to qualify for a full pension. This aspect of the CPP becomes less significant as the years pass.

Other benefits arising out of the CPP/QPP (such as disability benefits, survivor benefits, children's benefits, and death benefits) are also discussed in the appendix.

We shall reserve discussion of the similarity between the CPP and private plans in terms of how they are financed. However, a few observations relating to other comparisons are appropriate here. Unlike the typical private plan, the CPP locks in contributions and vests benefits immediately. In addition, the CPP is fully portable between employers. Workers not belonging to private pension plans receive CPP credits for all years in which their earnings were above the Year's Basic Exemption (YBE), which is currently $1,850. Thus, part-time employees and workers in the small business sector, who are typically not members of private plans, are covered by the CPP.

Finally, it is appropriate to point out that the workings of the CPP/QPP involve substantial transfers of costs to the next generation. As Table 20 below indicates, the accumulated assets of the CPP totalled $95 billion in 1981. The BCPP presents the following evaluation of the intergenerational transfers associated with the CPP:

> For an individual who has contributed since the inception of the plan in 1966 and is retiring in January 1, 1983, the accumulated joint contributions made by himself and his employer would provide about 16 per cent of the pension benefits he will receive in retirement. This percentage would be about 52 per cent for an individual retiring in the year 2008, that is 42 years after the inception of the plan. These percentages are overstatements because they do not take into account the benefits payable to a survivor on a contributor's death before retirement, or to a disabled contributor. In each case the balance of the value of the benefits to be received is effectively provided by the contributions of the current workforce after the individual has retired.[1]

This intergenerational transfer in the CPP/QPP will be dealt with in more detail in later chapters.

Overall public pension benefits: some profiles

We have now reviewed, albeit briefly, the major public programs that provide income support to the elderly. Table 5 provides a convenient summary of these programs by focusing on the support levels of single and married pensioners under various assumptions. While the table stands on its own, it is appropriate to highlight a few areas. Consider, first, row 1 of Table 5, which focuses on a married couple, both over 65 and neither a CPP recipient. Assuming that they have no other earnings, their total income is $12,735. This is composed of $6,099 from OAS, $4,720 from GIS and $1,915 from Ontario's GAINS. Now, let us assume that one spouse receives a maximum CPP pension of $4,141 (row 2 of Table 5). Their total income increases by only $162. This situation arises because of the confiscatory (i.e., 100 per cent) tax-back rates associated with the combination of GAINS and GIS.[2] The existence of any increase at all is due to the fact that the couple's eligibility for GAINS eventually runs out, dropping the tax-back rate from 100 per cent to 50 per cent. A similar,

TABLE 5
Yearly income support levels, March 1983, federal and provincial (Ontario)

		OAS	CPP	GIS	GAINS	TOTAL	TOTAL as percentage of low-income cut-offs[a]
1.	Married couple, both 65 Neither CPP recipient	6099		4720	1915	12,735	114%
2.	Married couple, both 65 Husband max. CPP	6099	4141	2657		12,897	116%
3.	Married couple, both 65, both receive max. CPP	6099	8283	592		14,974	134%
4.	Married couple, both 65 Husband receives avg. new CPP retirement benefit	6099	2916	3280	475	12,770	114%
5.	Married couple, both 65 Husband receives avg. CPP retirement benefit	6099	2318	3568	763	12,748	114%
6.	Single person, age 65 Non-CPP recipient	3049		3061	586	6,696	79%
7.	Single person, age 65 Receives max. CPP	3049	4141	997		8,187	97%
8.	Single person, age 65 Receives avg. new retirement benefit	3049	2916	1609		7,574	89%

TABLE 5 cont'd
Yearly income support levels, March 1983, federal and provincial (Ontario)

		OAS	CPP	GIS	GAINS	TOTAL	TOTAL as percentage of low-income cut-offs[a]
9.	Survivor 65+ receives max. CPP benefit	3049	2485	1825		7,359	87%
10.	Single - receives avg. CPP survivor pension	3049	1760	2185		6,994	83%
11.	Female, age 70, receives avg. CPP survivor benefits 1982	2795	1311	2151		6,258	74%

[a] Low income cut-offs are for 1-person and 2-person households located in an urban area with a population between 100,000 and 500,000 (see Table 13). Because 1983 benefits are being compared with 1982 low income cut-offs, the figures in the last column are biased slightly upward (except for row 11).

SOURCE: Whalley and Hamilton, with some additions.

though not quite so severe, result holds for a single pensioner. The addition of a maximum CPP raises a single person's total income by $1,491 (compare rows 6 and 7). The larger increase in this case is due to the fact that the level of GAINS for a single individual is low relative to that for each member of a couple.

There are several ways to view the problems associated with this interaction among the various components of income support. One view is that Ontario and the federal government ought to get their act together and resolve the problem of the 100 per cent tax-back rate on outside income. This problem is highlighted in the second column of Table 22 below, which shows marginal tax rates for an elderly married couple living in Ontario. For the first $3,844 of other income, including CPP, the marginal tax is 100 per cent. Between $3,844, once the GAINS threshold is exceeded, and $9,488, which is the GIS threshold, the rate is 50 per cent. At higher levels of income the standard marginal tax rates apply. We shall have more to say later about this peculiar schedule of marginal tax rates.

It is also interesting to view the public pension system as a whole. What Table 4 demonstrates is that combining a flat rate, universal benefit (OAS), income-tested benefits (GIS and GAINS), and an earnings-related benefit (CPP) effectively produces a flat distribution of benefits for those whose only source of retirement income is public pensions. In other words, all senior citizens are receiving roughly the same total amount in public pension benefits. The amount received by an individual eligible for the maximum CPP benefit, when combined with his OAS payment, is very close to the total received by someone who is not eligible for any CPP benefit, but who does qualify for the maximum GIS and GAINS payments.

If one assumes that these arrangements will remain in place, then expanding programs such as the CPP will have their principal impact on individuals or couples who are already above the poverty line. They will do little to enhance the income levels of those pensioners who are currently in need of additional support. Moreover, as noted above, these confiscatory tax rates provide substantial disincentives for low income workers to accumulate private savings or pension entitlements for retirement - unless, of course, their annual value will be in excess of the level that is subject to the 100 per cent tax (i.e., in excess of $3,844). To put the matter differently, if a married Ontario worker recognizes at age 64 that his annual retirement savings will generate an annuity of less than

$3,844 per year, he will quickly perceive that this annuity is worth exactly nothing. The incentive will clearly be to take the funds and embark on a spending spree - sheer consumption or perhaps investment in durable assets that are not offsets to GIS-GAINS - since this is the only way he can get any value out of the accumulated savings. This troublesome issue will crop up again and again in the analysis that follows.

We complete our brief description of the public and private pension systems by focusing on Registered Retirement Savings Plans (RRSPs). They occupy a middle ground between private and public pensions and could play a crucial role in overall pension reform.

APPENDIX 4A

CPP/QPP benefit formulas

The CPP/QPP benefit received by an individual retiring at age 65 is determined by the following formula:

$$PB_i = 0.25 \times \overline{YMPE} \times AER_i$$

where

AER_i = average earnings ratio of individual i

$$= \frac{1}{T} \Sigma \frac{PE_{i,j}}{YMPE_j}$$

PB_i = CPP/QPP benefit received by individual i

$\overline{YMPE}$ = average of Year's Maximum Pensionable Earnings over the three years ending with retirement

T = 85 per cent of number of years from 1966 to year individual reached age 65

$PE_{i,j}$ = pensionable earnings of individual i during year j starting with 1966

$YMPE_j$ = Year's Maximum Pensionable Earnings in year j starting with 1966

In calculating AER_i, the lowest 15 per cent of yearly earning ratios are dropped.

The YMPE for 1983 is $18,500. The average $\overline{YMPE}$ over the last 3 years has been $16,566. The YMPE is scheduled to increase by 12.5 per cent each year until it is equal to the Average Industrial Wage (AIW). The AIW in October 1982 was $20,450. Thus, the YMPE should catch up with the AIW in a few years' time.

Under the QPP benefit formula, those who drop out of the labour force to care for dependent children are allowed, when computing their AERs, to delete the earnings ratios of those years when their children were under the age of seven. The federal government and eight of the other provinces have passed the legislation necessary to introduce the 'child-rearing drop-out' provision into the CPP benefit formula. The government of Ontario has been able to block this provision by refusing to give its assent. However, in his 1983 budget statement, the then Treasurer of Ontario, the Hon. Frank Miller, indicated that Ontario was ending its opposition to the child-rearing drop-out provision and would soon pass the necessary amending legislation.

CPP/QPP benefits are fully indexed to the rate of change of the Consumer Price Index. The benefits must be declared as income for tax purposes.

Other benefits are paid under the CPP, including disability, survivor's, children's, and death benefits. To claim disability benefits, one must have contributed for at least five whole or part calendar years in the preceding ten-year period and must be suffering from a severe and prolonged mental or physical disability requiring withdrawal from the labour force. Benefits are payable four months after the disability occurs and consist of a fixed amount plus a computed value for the accrued retirement component. In 1983, the fixed amount is $78.60 per month plus 75 per cent of the contributor's retirement pension, calculated as if he had reached the age of 65 but with no allowance for extra contributory years.

Survivor's benefits under the CPP depend on the spouse's age, on whether or not there are children, and on whether or not the spouse is disabled. The deceased contributor must have contributed for either: (i) at least three calendar years and one-third of the number of calendar years in his contribution period or (ii) at least ten calendar years. Spouses who are disabled or who have dependent children receive a flat allowance of $78.60 per month plus 37.5 per cent of the retirement pension of the deceased (indexed to the CPI). On reaching 65, the surviving spouse receives 60 per cent of the deceased's pension, as indexed for inflation over the intervening period. Surviving spouses who are not disabled and have no dependent children receive the full spouse benefit at age 45, but the benefits paid to spouses between 35 and 44 are proportionately reduced (e.g., only 10 per cent of benefits are payable to a surviving spouse aged 35). The maximum monthly survivor benefit in 1983 was $208.03 for recipients under 65 and $207.09 for those over 65. A surviving spouse over age 65 can only receive survivor and retirement benefits up to the maximum CPP benefit of $345.15.

The CPP also provides benefits for dependent children of disability pensioners and surviving spouses. The maximum monthly benefit in 1983 was $78.60 per child.

Finally, death benefits are payable under the CPP if contributions have been made for at least one-third of the calendar years possible. If a contributor dies prior to retirement, a lump sum benefit is payable to survivors. The maximum benefit for 1983 is $1,850.

Details relating to the amounts paid out under the above categories appear in Table 4. Total payments under the CPP in 1982 were just under $2.5 billion, representing less than 25 per cent of all federal support payments to the elderly.

The Public Pension System: Council Summary Observations

- Unlike occupational pension plans, the public pension arrangements are not contractual in nature. This description applies even to the CPP/QPP. Rather, the public pension system tends to be characterized by intergenerational transfers.

- The public pension system incorporates the dual objectives of income support and income replacement. Since these objectives can be in conflict, it is not surprising that the many programs composing the public pension system sometimes generate peculiar or perverse incentives (e.g., GIS-GAINS tax-back rates).

- In terms of dollars, OAS, and not the CPP, is the backbone of the public pension system. This will remain the case even when the CPP matures.

- The CPP incorporates an immense transfer to the next generation. Under current contribution and benefit schedules, an individual who contributes for 42 years will have 'paid' for roughly one-half of the value of his retirement pension.

- For all intents and purposes, the present public pension system produces a flat distribution of benefits for those with no other sources of income. Thus, the addition of a maximum CPP pension of $4,141 to the income of an elderly couple increases the couple's overall annual income by only $162. This outcome is a result of the interaction between the goals of income suppport and income replacement.

- Some features of the public pension system do not appear to be consistent with either income support or income replacement. For example, the age and pension deductions under the provisions of the income tax regulations deliver benefits that increase with increasing income.

5
RRSPs

RRSP characteristics

Registered Retirement Savings Plans (RRSPs) occupy a unique position in the system of pension arrangements. They have the same tax privileges as a regular registered pension and are available for annual contributions from individuals without occupational pension plans of up to 20 per cent of earned income or $5,500, whichever is lower. Members of an occupational plan are limited to annual RRSP contributions of $3,500, less the employee contributions for that year. RRSPs can be self-administered or managed by a financial institution. In effect, they are individually owned money-purchase plans.

While RRSPs provide a convenient and attractive way for Canadians to enhance their retirement incomes, there are several concerns that have to be raised relating to their role in the overall pension system.

First, RRSPs are not solely a pension instrument. Funds in an RRSP are not locked in - they can be withdrawn into regular income in any taxation year. This feature effectively converts RRSPs into income-averaging arrangements. However, under an income-averaging scheme, interest income ought to be included in taxable income as it accrues rather than on redemption, as is currently the case for RRSPs. Second, many taxpayers utilize payments into the system, which are deductible at their own marginal rate, to create RRSPs for their spouses. Under certain conditions, which amount essentially to a waiting period, these funds can be withdrawn and treated as taxable at the spouse's marginal rate. Both of these uses for an RRSP can be justified under various approaches to taxation. For example, the former use is fully consistent with an expenditure tax, while the latter use can be likened to a move toward income-splitting (i.e., dividing family income equally between the spouses), which is a characteristic of the U.S. income tax system. However, they do not square very well with the RRSPs role as a device for enhancing retirement incomes.

Third, the RRSP vehicle is not used extensively by some of the very groups for which it was designed. For example, the Green Paper notes that not as many of the self-employed (who do not qualify for occupational plans) have contributed to RRSPs as might have been expected. Of the almost 1 million self-employed men and women who contributed to the CPP or QPP in 1979, over 720,000 did not make a contribution to an RRSP in that year. There are, of course, many reasons why the self-employed might avoid RRSPs, including the fact that ploughing funds back into the business is an alternative way of providing for retirement income.

Some data on RRSPs

Table 6 presents data for 1979 on contributions to RRSPs by income class. Very few taxpayers in the lower income classes contributed to RRSPs - only .6 per cent of tax filers with incomes under $6,000, with an average contribution of $456. In each successively higher income group, without exception, both the percentage of tax filers who take advantage of RRSPs and the average contribution increase. Thus, 59.2 per cent of tax filers in the over-$40,000 income group took advantage of RRSPs, making an average contribution of $3,752.

The data for 1980 indicate that 1.9 million Canadians made RRSP contributions for an overall annual total of $3.7 billion.

Equity and RRSPs

It should not be surprising that RRSPs are more appealing to those in the higher income classes. There are two factors at work here. First, because RRSPs are deductible for income tax purposes, it effectively costs a person in the 50 per cent tax bracket only $500 to put $1,000 in an RRSP. For persons in the 25 per cent bracket, it costs $750 to put $1,000 in an RRSP. And for a person who has no tax owing, there is no tax advantage associated with an RRSP contribution. Second, for those in the low income category the benefits of having RRSP-related pensions will be reduced by a factor of one-half if they become an offset for GIS. And for Ontarians, if they are eligible for GAINS, the offset will be 100 per cent.

This is the dilemma. Some program like GIS is necessary to ensure

TABLE 6
RRSP contributors by income group, 1979

Income group	No. of contributors	% of tax filers	Average contribution
under $6,000	29,114	0.6	$456
$6,000-$7,999	41,092	3.3	$742
$8,000-$9,999	69,412	5.8	$863
$10,000-$11,999	98,928	8.7	$951
$12,000-$13,999	118,092	11.7	$1,053
$14,000-$15,999	127,813	14.7	$1,218
$16,000-$17,999	137,555	17.0	$1,354
$18,000-$19,999	143,003	20.8	$1,440
$20,000-$24,999	322,965	26.7	$1,672
$25,000-$29,999	227,624	36.0	$1,986
$30,000-$34,999	145,480	46.2	$2,282
$35,000-39,999	83,650	52.4	$2,594
over $40,000	181,231	59.2	$3,752
Total	1,725,959	11.8	$1,791

SOURCE: Statistics Canada (1980) *Pension Plans in Canada* (Ottawa) p. 94.

that all elderly individuals and couples can achieve at least a poverty-level standard of living. On the other hand, we have no reason to question the Green Paper when it notes that Canadians generally wish to receive pensions as a matter of entitlement - pensions that they have contributed to throughout their lives - rather than be dependent on GIS. Therefore, while low-income Canadians are the very group that ought to be given some incentive to provide for retirement, it is also the group that under existing arrangements faces the greatest disincentive to save. Our background research suggests that there is likely a case to be made for *subsidizing* the pension contributions of this group. One approach would be to convert RRSP contributions into a refundable tax credit of, say, 35 per cent, or at least to allow the taxpayer to choose between the tax credit and the tax deduction. This would mean that for each $1,000 put into an RRSP, the dollar cost would be $650. The $350 would be used to reduce taxes otherwise paid, and if no taxes were owing the $350 would take the form of a refund to the contributor.

RRSPs and pension reform

RRSPs loom large in pension reform. This prominance is chiefly due to the Green Paper's proposal of a new pension vehicle, the Registered Pension Account (RPA), that would be essentially a locked-in RRSP into which both employees and employers could make tax deductible contributions. This is a very significant innovation and we shall devote an entire chapter to its evaluation.

A second Green Paper suggestion is that, in the interests of 'fairness', there ought to be upper limits to the amount of lifetime contributions that any one individual can make to RRSPs.

Finally, there appears to be considerable pressure on the federal government to expand the maximum RRSP contribution limits. The argument, in part, is that these limits, which have not been altered since 1975, have been eroded by inflation.

Part of the problem (and part of the advantage as well) is that the RRSP as presently constituted is serving multiple purposes. One potential role of the reform process would be to sort out these various purposes and then identify or design the vehicles most appropriate to them. These issues will be taken up later.

Conclusion

This completes our brief overview of the public and private pension systems. The remainder of our survey of the status quo focuses on some of the problems relating to the existing arrangements. We begin with an analysis of the financial obligations of the public system.

RRSPs:
Council Summary Observations

- RRSPs are very flexible instruments capable of performing multiple functions - income averaging, tax deferral, income-splitting between spouses, and sheltering of income for retirement.

- RRSPs are used principally by high-income taxpayers. Of persons with incomes above $35,000, over 50 per cent make contributions to RRSPs. For persons with incomes below $12,000, the rate of contribution is well below 10 per cent. In addition, the average dollar contribution rises with the level of income.

- There are at least two reasons why RRSPs are more attractive to high-income than to low-income people. First, since contributions are tax deductible, the after-tax cost of contributions falls as a person's marginal tax rate rises. Second, the RRSP benefits of those who cannot put much income away for retirement would be subject to the high or confiscatory tax-back rates associated with GIS-GAINS.

- If RRSPs are deemed to be principally vehicles for enhancing retirement savings, then two modifications seem appropriate in the interests of 'fairness': first, the present tax deduction approach might be converted to or supplemented by a refundable tax credit approach so that all Canadians, regardless of income class, would have an incentive for putting funds in RRSPs; second, some minimum contribution levels might be introduced, up to which all Canadians would have a right to contribute. The latter provision would imply that if people did not take advantage of RRSPs early in their working lives, perhaps because of adverse income prospects, they would be able to make retroactive payments up to this minimum level later in their working lives. This minimum lifetime contribution level would appear to be a natural companion to the Green Paper's recommendation for maximum lifetime contribution limits.

6

Financial Implications of the Existing Public Programs

The dimensions of the problem

Most of the discussion of the financial implications of the public pensions has focused on the unfunded future liabilities of the Canada Pension Plan. This is indeed a critical and complex area. Once again, however, it is important to recognize that the CPP/QPP currently accounts for only 25 per cent of total government income support payments to the elderly. This proportion will no doubt increase somewhat as the CPP matures and more retirees acquire rights to a full pension. Nonetheless, it is also the case that if the present arrangements continue the combination of OAS and GIS will still account for the majority of income flows for the elderly. Thus, whatever adjustments in financing are required to sustain the maturing of the CPP, the CPP will still account for less than half of the overall financing requirements of the public pension system.

One must also take into account the likely cost of other services for the elderly, such as hospital and medical services. A very rough estimate contained in the background research suggests that as much as one-third of our present health care costs are accounted for by the 8 per cent of the population over 65. This figure represents about six times the present expenditure on CPP benefits. The federal Green Paper on pension reform anticipates a substantial increase in CPP contributions, from the present 3.6 per cent to the 10 per cent range by 2020, in order to maintain existing CPP benefit arrangements. Yet this increase will be considerably smaller than the increase in 'hidden' contributions - that is, in taxes - that will be needed to finance OAS, GIS, and health care costs. This prospect, significant in its own right, is critical to the evaluation of proposals for reform that would involve substantial further financing requirements.

The CPP financing requirements

The provincial indebtedness

When the CPP was established in the mid-1960s, it was designed to be, initially, a partially funded scheme. For a substantial period contributions into the program would exceed benefits. This excess would be turned over to the provinces. Each province is currently allowed to borrow from this annual surplus an amount proportional to the contributions paid by residents of that province. For their part, the provinces issue securities for the money they borrow. The interest rate on these provincial issues is set at the rate on long-term Government of Canada securities. The provincial securities can be redeemed on six months' notice by the Minister of Finance. As interest accumulates, it is added to the provinces' indebtedness to the fund.

Table 7 shows the provinces' accumulated indebtedness to the CPP as of March 1983. The table also shows the proportion of each province's total debt represented by CPP borrowing. These data relate to March 1981. Of the $23 billion the provinces owe to the CPP, Ontario's indebtedness is over $12 billion. This represents 45.8 per cent of Ontario's overall provincial debt outstanding.

Note that the table refers only to the CPP and not to the QPP. A separate study in our background document is devoted to the structure and investment policy of the QPP. The current net assets of the QPP are just under $9 billion. As noted in Chapter 4, the current assets of the CPP amounted in 1981 to some $20 billion, while its unfunded liabilities up to 1981 were $95 billion.

It will clarify the relationship between the provincial indebtedness and the financing of the CPP to focus on three 'critical years.'[1]

(1) Critical year No. 1: benefits equal contributions

If present arrangements continue, then 1985 is likely to be the first year in which annual contributions into the CPP fall short of benefits paid out. In other words, the annual flow position of the fund will be negative. A call to the provinces to account for the shortfall would oblige them to deliver to the fund an increasing proportion of the interest owing on their loans. Since the total annual interest owing would be less than

TABLE 7
CPP provincial indebtedness, March 1983

Government	Amount owed ($ millions)	% of total	% of total provincial debt held by CPP
Newfoundland	472.3	2.1	14.8
P.E.I.	98.0	0.4	20.8
Nova Scotia	901.9	3.9	27.9
New Brunswick	680.9	3.0	29.7
Quebec	99.1	0.4	0.5
Ontario	12,299.7	53.6	45.8
Manitoba	1,313.0	5.7	33.2
Saskatchewan	1,026.5	4.5	29.8
Alberta	2,436.2	10.6	38.4
B.C.	3,436.5	15.0	96.3
Canada	171.4	0.7	-
Total	22,935.5	100.0	

SOURCE: Health and Welfare Canada (March 1983) Canada Pension Plan Statistical Bulletin.

the annual cost shortfall of the plan, the size of the fund (i.e., the provincial indebtedness) would continue to increase.

(2) Critical year No. 2: benefits equal contributions plus provincial interest payments

In 1993 or thereabouts, the second critical point will be reached, namely the time when the annual flow deficit in the CPP equals the annual interest owed to the fund by the provinces. This is the period in which the fund will reach its maximum value, i.e., the period in which provincial indebtedness to the scheme will be at a maximum. Beyond this point, provincial payments to the fund will exceed the annual interest owing and the provinces will, therefore, be repaying the principal.

(3) Critical year No. 3: the fund is exhausted

Current projections suggest that if the existing contribution and benefit arrangements prevail, the provinces will have run down their indebtedness to zero by the year 2003. In other words, the CPP fund will be exhausted.

It is frequently claimed that from 2003 onward, contribution rates will have to be increased to match benefits, thereby putting the CPP on a pay-go basis. This is misleading, since under reasonable interpretations the CPP will, in effect, be on a pay-go basis in 1985. The following section elaborates on this point.

The nature of the CPP fund

Is it appropriate to suggest that there exists a CPP fund? The answer is both 'yes' and 'no'. That the provinces owe the Canada Pension Plan billions of dollars is, of course, true. In this sense the CPP has some 'assets' and can be said to be 'funded', albeit only partially. However, if the provinces are called upon to repay their indebtedness to the fund, they will be able to do so only by raising provincial taxes, cutting expenditures, or running deficits. Since this is exactly what the federal government will have to do in 2003, when the 'fund' is exhausted, the fact of the matter is that the CPP will be on a pay-as-you-go basis in 1985.

Thus, when the first of the three critical years arrives (i.e., 1985), the federal government (or, more appropriately, the Canada Pension Plan) is going to have to decide whether it will insist that the provinces provide the cash-flow shortfall in the scheme, in which case the provinces will probably raise their tax rates, or whether it will forgo drawing funds from the provinces, in which case contribution rates will have to be increased to cover the financing. There is also a third, rather unlikely, option - the federal government will finance the shortfall out of its own general revenues. In principle there could be a considerable difference between the first two options, since the different government might choose different ways to finance the shortfall. In practice this is unlikely: the provinces would probably attempt to impose a payroll tax, which, for all intents and purposes, would be identical to an increase in the CPP contribution rates. Indeed, since the provinces have the right to initiate a change in CPP contribution rates, there may be no difference at all between these two options.

Therefore, there is no 'fund' in the sense of a pool of assets that can be utilized to provide CPP benefits without resort to increased taxes, or contribution rates, or deficits. It is important to point out, however, that this need not imply that the CPP fund has been 'wasted' or 'dissipated'. To the extent that this $23 billion or so dollars has been used to put in place social capital (i.e., schools, roads, hospitals) or development capital, the benefits will show up in higher earnings and a higher living standard. In the most optimistic scenario, therefore, the 'fund' contributes to greater incomes and, therefore, to enhanced ability on the part of workers to finance future CPP requirements. However, to the extent that these provincial borrowings have been used to provide greater expenditures on final goods or to reduce taxes, the 'benefits' have been consumed by the current generation. In other words, the fund has simply been a tax-transfer device affecting the current generation.

Probably both descriptions characterize the fund to some degree. However, it is also appropriate to recognize that the fund is made up of future liabilities of the provinces to the CPP. Thus future taxpayers are responsible not only for making up any CPP shortfall once the fund is exhausted, but also for liquidating the province's indebtedness to the fund. It is in this important sense that the CPP's financing arrangements are pay-go - effectively from here on in and not from 2003!

It is also in this sense that the CPP represents an intergenerational transfer. While it is commonplace to assume that the financing of the future liabilities of the CPP will require an increase in CPP contribution rates, the fact that the CPP is an intergenerational transfer and not a contractual arrangement implies that it can be financed in any way that future governments decide.

Later in this report we shall address the federal-provincial implications of the Canada Pension Plan. For the present we note just two items. First, Ontario has an effective veto on any changes in the CPP. Second, and relatedly, it is probably not the case that the federal government can take any position it wishes respecting the provincial bond issues that the CPP holds. Should Ottawa require that the provinces pay back the full amount of their indebtedness, the option remains open to the provinces individually or as a group to follow Quebec's lead and take over full responsibility for the CPP.

The CPP's future liabilities

It should come as no surprise that the present contribution rates will be insufficient to fund the CPP when it matures. They were not designed to be sufficient. This is a statement of fact that in no way diminishes the magnitude of the financing problem presently facing the CPP. But it is important to set the historical record straight. Thus, the CPP was set up as a 'partially funded' plan. Future increases in the contribution rate were fully anticipated at the outset of the program. With no change in the demographic structure of the population and no change in the benefit structure, the combined contribution rates will have to rise from the current 3.6 per cent to somewhere near 8 per cent. This rise will be necessary simply because the CPP is maturing. At the inception of the program those who had already turned 65 were not eligible for benefits, and many of those who became 65 later had not logged enough contributions to qualify for full entitlements. With the passage of time, however, more and more retirees qualify for full benefits. When all of the elderly in our society began their working lives under the CPP provisions, the CPP will be 'mature' - and correspondingly more expensive. There will be some cost offsets. For example, as more retirees become eligible for the full CPP, expenditures on GIS will fall.

The impact of demographic change

There is, however, another factor that will substantially increase the CPP financing requirement. This is the aging of the Canadian population. As time passes, there will be proportionately more CPP recipients and proportionally fewer working-age people to support them. If current arrangements continue, then the result of this double impact on the CPP will be higher contribution rates.

Thus the critical question is: what will be the extent of the change in our age structure? The honest answer is that we do not know. Projections involve assumptions about fertility, mortality, immigration, and work-force participation. Table 8 reproduces recent projections to 2051, prepared by Denton, Spencer, and Feaver for the Economic Council of Canada. The 'baseline', or most likely projection, indicates a doubling of the proportion of the 65-plus population over the period 1977 to 2051. In the 'pessimistic' variant, the proportion of elderly triples, while in the

TABLE 8

Denton-Feaver-Spencer[a] projections of percentage of population 65 years and older, Canada, 1976-2051

Year	'Baseline' projections	'Pessimistic' variant	'Optimistic' variant
1976	8.7	8.7	8.7
1981	9.4	9.6	9.2
1986	10.0	10.4	9.4
1991	10.7	11.6	9.7
1996	11.2	12.5	9.8
2001	11.5	13.2	9.7
2006	11.7	13.8	9.5
2011	12.4	15.2	9.6
2016	13.9	17.4	10.2
2021	15.4	20.0	10.9
2026	17.2	22.9	11.6
2031	18.3	25.3	11.8
2036	18.2	26.3	11.0
2041	17.5	26.6	10.0
2046	17.3	26.7	9.8
2051	17.6	26.7	10.3

[a] Frank Denton, Christine H. Feaver, and Byron G. Spencer (1980) *The Future Population and Labour Force of Canada, Projections to the Year 2051* (Ottawa: Economic Council of Canada) Table 5-4, p. 32.

optimistic variant it increases only slightly.

The federal government's Green Paper forecasts an increase in contribution rates to around 10 per cent by the year 2030. The demographic shift underlying this forecast has approximately 20 per cent of Canada's population in 2030 in the 65-plus category. This is roughly in line with the 'baseline' projection in Table 8.

Forecasting the required contribution ratio also requires assumptions about interest rates, inflation, earnings levels, and labour-force participation over the next fifty years. All in all, a formidable task. Yet a critical one. The Green Paper simply did not devote enough time and attention to spelling out the *range of uncertainty* associated with forecasting the cost of the *present* set of CPP arrangements. The background study by Leroy Stone and Susan Fletcher focuses on several reasons why we ought to be cautious in accepting any specific forecast of dependency ratios in the 21st century.

Given that the future costs of the current arrangements are so uncertain, the notion of doubling the CPP, as several interest groups have suggested, is not the sort of proposal that is easy to evaluate. It should be noted, finally, that the effects of any errors in forecasting the age structure are likely to be cumulative rather than offsetting. If one underestimates the proportion of 65+ in 2020, one underestimates not only the cost of financing the CPP, but also the costs of OAS-GIS and the medical and hospital costs of the elderly. As noted above, these costs are currently much larger than those associated with the CPP/QPP.

The intergenerational issue

Thus far the analysis in this chapter has proceeded on the assumption that there is a program in place and the question is simply one of how to finance the future obligations of the plan. However, there is a somewhat different way to view the issue. It begins with the premise that the CPP, like most other public programs, is not contractual. Present governments cannot bind future governments with respect to either the financing or the benefit structure of the CPP.

The first observation to be made is that, over the longer term, the present contribution and benefit structures are inconsistent. Something has to give. At one extreme, the governments can maintain the present structure of benefits. To do so they will have to generate some present and future financial arrangements that will support the benefit levels. This additional financing may or may not come in the form of increased CPP contribution rates. It may well be appropriate to view the financing in the broader context of the overall structure of taxation in the nation. This is in part what is meant by the claim that the CPP is not a contractual arrangement.

At the other extreme, future or even present governments can roll back CPP benefits to make them consistent with the present contribution schedule. Naturally, all combinations of these extreme approaches are also possible.

In this broad view, these considerations apply to OAS and GIS as well as to the CPP/QPP.

At issue, therefore, is an intergenerational decision that cannot be avoided. The alternatives are to retain the present benefits and increase taxes and/or contributions or to reduce the benefits and retain the present contribution schedule. The first alternative treats the current generation in the same manner as the preceding one, but works to the relative disadvantage of future generations. The second alternative treats the current and future generations in the same manner, but puts them both at a disadvantage relative to the preceding generation.

Thus, some intergenerational equity judgment is inescapable with respect to both the CPP and OAS, etc. In large measure, this is what is implied by our earlier claim that, at base, the public pension system represents an intergenerational transfer.

While the Council recognizes that, in principle, programs such as the CPP are non-contractual, we also recognize that there is a widespread perception among Canadians that they are contributing to CPP entitlements. Thus, there is a sort of implicit social contract in place in the minds of most Canadians. This being the case, the Council believes that the most desirable modifications to the present pension system are precisely those that future governments can be expected to honour. This influences much of our thinking in the remainder of the document.

Financial Implications of the Existing Public Programs: Council Summary Observations

- The existing pension system incorporates very substantial transfers of costs to the next generation. For example, one recent estimate suggests that of the $115 billion worth of pension promises already accrued under the CPP by the end of 1981, only $20 billion is backed by provincial indebtedness. The intergenerational transfer is much larger for the OAS program.

- The present set of public pension arrangements (the combination of tax and contribution rates on the one hand and the structure of benefits on the other) is simply not sustainable. Maintaining the present structure of benefits into the 21st century would require a very substantial increase in taxes and/or contributions. Maintaining the present tax and contribution structure would require a substantial rolling back of benefits to the future elderly. The status quo cannot be maintained. Moreover, any decisions that are made will, of necessity, have to incorporate judgments relating to intergenerational equity.

- Most of the discussion of the financing problem of the public pension system is conducted within the context of the CPP/QPP. This is far too narrow a framework. Even on maturation, the financial implications of the CPP/QPP will, under the present structure, be smaller than those associated with either OAS/GIS or the health costs of the elderly.

- Substantial uncertainty attaches to the forecasts of the proportion of the population that will be over 65 in the 21st century. Unfortunately, any forecasting errors will be cumulative - not offsetting - in terms of their cost impact. Underestimating the proportion of the population that will be over 65 would not only increase the financing requirements for all public sector pension arrangements but also spread the costs of this support over a smaller-than-estimated work force.

- With respect to the CPP, there are important decisions to be made relating to the present provincial indebtedness. On one interpretation, the CPP is essentially on a pay-as-you-go basis now. The only question is which level of government will levy the tax or contribution increases.

- More generally, the public pension system is non-contractual in the sense that present governments cannot bind future governments with respect to either the financing or the benefit structure. This being the case, a principle underlying the Council's approach to these issues is that any modifications to the structure of public pensions should be designed with an eye toward maximizing the probability that future Canadians will find them reasonably equitable and that future governments will, in consequence, honour them.

7
Income Support and the Elderly

Income support and income replacement

One way of evaluating the adequacy of our overall public pension system is to ascertain how well it performs in providing income support. That the elderly enjoy a decent standard of living is an almost universally agreed-upon objective of the public pension system. A second goal for the public pension system, recently emphasized by the Green Paper and various interest groups, is that it should provide some minimum 'replacement' of pre-retirement earnings. The Green Paper views this as one of the three 'principles' of pension reform, namely that 'Canadians should be able to avoid serious disruption of their pre-retirement living standards upon retirement'. Certainly all Canadians are in favour of a system that allows individuals to achieve adequate replacement. What is not so clear is whether the principal responsibility for providing income replacement lies with the public pension system or with the private system.

Although the two concepts are related, we shall focus in this chapter on income support,[1] leaving to Chapter 8 the analysis of how the elderly fare in terms of income replacement.

Income support and the elderly: some statistics

Data on the income position of the elderly are given in Tables 9 and 10, which report the distribution in 1980 of relative incomes of family groups and unattached individuals cross-classified by age and sex. As Table 9 shows, the average income of families 65 and over is significantly lower than the average income of all families, with a large concentration of incomes of the former in the range of $7,000 to $12,000 per year. Thus elderly households are unambiguously and significantly poorer in income

TABLE 9
Relative incomes of family groups, 1980 percentage distributions

Family incomes	All families		Male head		Female head	
$,000	All age groups	65 & over	All age groups	65 & over	All age groups	65 & over
<5	2.8	2.5	1.6	2.0	13.6	6.4
5-7	3.0	3.4	1.7	2.9	14.9	7.7
7-10	7.0	23.2	6.2	24.3	13.9	13.4
10-12	4.6	12.8	4.2	13.7	7.9	5.1
12-13	1.9	4.5	1.8	4.5	2.7	5.1
13-14	1.9	3.4	1.7	3.4	3.6	3.5
14-15	2.3	3.9	2.2	3.6	2.7	6.5
15-16	2.3	3.0	2.1	2.6	4.5	7.2
16-17	2.5	2.8	2.4	2.7	3.5	4.2
17-18	2.7	2.9	2.6	2.7	3.3	4.3
18-20	5.2	5.5	5.3	5.6	4.5	4.9
20-22	5.1	4.0	5.4	4.2	2.2	2.6
22-25	8.1	5.6	8.5	5.7	4.9	4.8
25-30	13.8	7.2	14.5	7.2	7.8	7.5
30-35	11.1	4.8	11.8	4.7	5.0	5.7
35-40	8.6	3.2	9.3	3.0	2.1	5.0
40-45	5.5	1.5	6.0	1.5	0.7	1.1
45+	11.7	5.7	13.7	5.8	2.1	4.9
All incomes	100.0	100.0	100.0	100.0	100.0	100.0
Average income	$27,398	$19,185	$28,781	$19,201	$14,969	$19,048
Median income	$25,244	$14,055	$26,494	$13,770	$11,931	$15,316

SOURCE: Statistics Canada (1982) Income Distributions by Size in Canada, 1980 (Ottawa) Table 4, pp. 40-41.

terms than households generally. A particularly sharp difference is noticeable in the average and the median incomes: only a small difference occurs between the average and the median for all households, while for the elderly households the gap is much more pronounced - $27,000 vs. $25,000 for the former and $19,000 vs. $14,000 for the latter.

Nonetheless, the average for the elderly group is around $19,000 per year. The fact that in 1980 the average public pension income of households 65 and over was around $10,000 per year suggests that the average income of all families 65 and over may be approximately double the income support generated by the public pension system. This suggests that for the average elderly household there are substantial income resources avail-

TABLE 10
Relative incomes of unattached individuals, 1980 percentage distributions

Individual Incomes $,000	All unattached individuals		Males		Females	
	All age groups	65 & over	All age groups	65 & over	All age groups	65 & over
<2	6.1	0.5	5.9	1.0	6.2	0.3
2-3	3.9	3.8	2.9	4.1	4.7	3.7
3-4	5.3	4.3	4.5	3.8	6.0	4.5
4-5	11.0	25.3	6.4	19.2	14.6	27.7
5-6	10.4	23.5	7.8	20.2	12.5	24.8
6-7	5.5	9.9	5.0	12.6	5.9	8.8
7-8	4.1	5.4	4.5	6.6	3.8	4.9
8-9	4.8	4.3	4.7	4.2	4.9	4.3
9-10	3.8	2.8	3.3	2.9	4.1	2.8
10-12	6.7	4.4	6.4	4.5	6.8	4.3
12-15	9.6	4.8	9.1	6.3	20.0	4.2
15-20	12.1	5.2	16.1	6.3	9.0	4.8
20-25	8.7	3.4	11.7	4.1	6.4	3.2
25+	8.0	2.4	11.8	4.2	5.0	1.7
All incomes	100.0	100.0	100.0	100.0	100.0	100.0
Average income	$11,403	$8,165	$13,461	$9,582	$9,776	$7,607
Median income	$ 8,761	$5,684	$11,587	$6,135	$6,998	$5,556

SOURCE: Statistics Canada (1982) Income Distributions by size in Canada, 1980 (Ottawa) Table 23, p. 56.

able beyond those made available through public pensions, although a significant number of households are clearly heavily dependent on this support and many are entirely dependent on it.

Table 10 presents the income positions of unattached individuals. The average income of all unattached individuals 65 and over was $8,000 per year in 1980, while the median income was only $5,600. This median income is approximately the amount of income available under public sector income support programs, which suggests that the bottom 50 per cent of elderly individuals (as against households) have basically no source of income besides public pensions. Moreover, for unattached individuals there is a sharp difference in income between males and females: for females the average income is only $7,600 per year and the median income $5,556. In addition, the majority of unattached individuals over 65 are female rather than male, emphasizing the crucial importance of pension

TABLE 11

A. Average income and wealth of families and unattached individuals by age of head, Canada 1977

Age of head	Average income $	Average wealth $	Ratio of wealth to income	Percentage of home ownership	Percentage with mortgage among home owners
<24	9,444	5,466	0.58	12.2	82.6
25-34	16,443	23,664	1.42	52.9	85.6
35-44	20,395	57,257	2.81	72.7	75.1
45-54	21,056	74,405	3.53	74.4	53.9
55-64	16,818	70,300	4.18	70.4	31.3
65+	8,604	47,074	5.47	62.6	9.7
All groups	15,849	46,273	2.92	59.6	54.0

B. Percentage composition of families and unattached individuals by age of head, Canada 1977

		Percentage composition of wealth				
Age of head	Average wealth	Financial assets	Cars	Equity in home	Non-home real estate	Equity in business or farm
<24	5,466	-7.3	29.9	36.2	7.8	33.4
25-34	23,664	6.0	10.8	49.7	9.0	24.6
35-44	57,257	16.3	4.9	44.3	10.1	24.5
45-54	74,405	14.3	4.2	41.9	10.4	29.1
55-64	70,300	23.2	3.4	40.3	10.3	22.8
65+	47,074	33.2	2.6	46.0	8.9	9.2
All groups	46,273	18.7	5.0	43.7	9.8	22.7

SOURCE: Statistics Canada (1979) *The Distribution of Income and Wealth in Canada, 1977* (Ottawa) Tables VI and VIII.

reform to single elderly females, many of whom are surviving spouses.

Tables 9 and 10 provide data only with respect to the *incomes* of the elderly, neglecting their wealth. Table 11 reports information on the average income and wealth of various groups classified by both age and wealth for 1977. What is noticeable is that the group that is 65-plus in 1977 has both significantly lower incomes and lower wealth than other age groups in the economy. Among this group a large portion of wealth is in home ownership, and by and large mortgages have been paid off. A significant number of the elderly have private pensions and various forms of investment income, but inequality among the elderly is probably more pro-

TABLE 12
Composition of incomes of the elderly, 1976

	Unattached individuals			Married couples			Total		
	(a) Who received private pension income	(b) Who received no private pension income	(c) Both	(a) Who received private pension income	(b) Who received no private pension income	(c) Both	(a) Who received private pension income	(b) Who received no private pension income	(c) Both
Average family income	$ 6,879	$ 4,331	$ 4,995	$12,189	$ 8,749	$10,165	$10,781	$ 7,567	$ 8,604
Composition of income (percentage)									
Earned income	5.1	12.6	9.9	18.8	35.9	27.4	22.4	36.7	29.2
Investment income	25.9	27.6	27.0	21.4	18.4	19.9	19.6	19.2	4.9
Government transfers									
OAS/GIS	25.7	47.4	39.6	24.7	36.3	30.5	23.0	33.4	29.2
CPP/QPP	6.7	4.4	5.2	6.5	5.2	5.8	6.1	4.1	4.9
Other	2.2	5.1	4.1	1.3	3.0	2.1	1.9	4.9	3.7
Pension income	33.9	--	12.1	26.8	--	13.2	26.2	--	10.6
Other money income	0.4	2.9	2.0	0.6	1.1	0.9	0.7	1.7	1.3
Proportion of females (%)	68.6	71.8	71.0						
Proportion of widows/ widowers	76.0	80.8	79.5						
Estimated numbers (000)	173	490	662	208	297	505	449	944	1,393
Average 1976 family wealth	$37,820	$28,287	$30,770	$67,966	$54,666	$60,141	$56,244	$47,712	$47,074
% of wealth in home	46.5	49.4	48.5	46.2	47.0	46.6	46.6	45.6	46.0

SOURCE: Canadian Statistical Review (March 1981).

nounced than inequality within other cohorts of the population. Thus, a common situation among the current elderly is to receive a small non-public pension income and to have one's wealth largely in one's home.

A more complete picture of the income situation of the elderly can be gained from Table 12, which reports the composition of their incomes. A striking feature is the large portion of the income of the elderly which accrues as earned income. For married couples who received no private pensions, earned income is as important in their overall income picture as OAS/GIS. When earned income is combined with investment income, the two generally exceed OAS/GIS for most categories in Table 12. In contrast, CPP/QPP never amounts to more than 6.7 per cent of total income, although this proportion will increase considerably as the CPP matures. There are differences between unattached individuals and married couples: the former earn significantly less than the latter. Differences also occur between those who receive private pension income and those who do not: the former earn less than the latter. Again, the picture that emerges is of an elderly group that receives a significant amount of income other than public pension income, but within which a substantial segment is almost totally dependent on government income support.

Pensioners and poverty lines

Some observers have proposed that the public pension system guarantee that all senior citizens are above the 'poverty line'. However, this proposal brings up the difficult business of deciding where the 'poverty line' is. A number of organizations have attempted to construct such poverty lines.

Statistics Canada annually reports a set of income levels that are generally referred to as 'poverty lines'. However, Statistics Canada itself calls these figures 'low income cut-off levels' and not poverty lines:

> ...the cut-offs are not poverty lines and should not be so interpreted. The setting of poverty lines necessarily involves a value judgement as to the level of minimum income below which an individual or family would generally be regarded as 'poor'. No such judgement has been attempted now or previously in constructing the low income cut-offs. Rather, these cut-offs were designed in response to the need to quantify the numbers and characteristics of individuals and families falling into the lowest income category - defined in relative terms taking into account current overall levels of living.[2]

TABLE 13
Statistics Canada low income cut-offs, 1982

Size of Household	Size of area of residence: 500,000+	100,000-500,000	30,000-100,000	Small urban	Rural
1	$ 8,914	$ 8,466	$ 7,941	$7,342	$6,592
2	$11,761	$11,162	$10,414	$9,663	$8,615

A separate set of low-income cut-offs is computed for each size of household to allow for the fact that living costs per person decline as household size increases. In turn, the cut-offs for each household size are differentiated according to the population density of the area in which the household is located. This is done to allow for the fact that living costs tend to be higher in areas with a high population density. The 1982 Statistics Canada low income cut-offs for one- and two-person households appear in Table 13.

With regard to Canadians aged 65 and over, Statistics Canada's low income data show that unattached individuals (unmarried people living alone) are much worse off than senior citizens living in households of 2 or more persons. It is estimated that 58.6 per cent of senior citizens living alone in 1981 had incomes below the cut-off levels. This compares with an estimate of 14.5 per cent of households headed by a senior citizen being below the low income cut-off.

According to the most recent estimates, almost half of Canadians aged 65 and over are unmarried. Roughly three-quarters of these unmarried senior citizens are women. The high proportion of women among single senior citizens is due in large measure to the longer average life expectancy of women. Slightly more than half of these single senior citizens live in households with other adults or are being cared for in institutions. However, that still leaves more than 500,000 senior citizens living alone. Thus, the 58.5 per cent estimate does apply to a substantial number of senior citizens. However, Statistics Canada also warns that:

> The low income cut-offs do not take into account a number of important factors such as wealth (e.g., home ownership and mortgage indebtedness), access to subsidized goods and services, future earnings potential, etc., and as a result, while many individuals or families falling below the

cut-offs would be considered in 'poverty' by almost any Canadian standard, others would be deemed by most to be in quite comfortable circumstances.[3]

The most important of these factors in the case of the elderly is home ownership. The incidence of home ownership with no mortgage is highest among the 65-and-over age group. A homeowner generally has lower living costs and is, therefore, likely to be better off than another individual with the same money income who lives in rented accommodation. It is, of course, true that the incidence of home ownership rises with money income. Thus, we should not expect that all senior citizens who fall into the low money income category enjoy the advantages of home ownership. We should, however, be aware that, of those senior citizens with low money incomes, renters are likely to be worse off than homeowners. Even this statement has to be qualified: renters who have access to the generous rental subsidies provided by some provinces are obviously in a much better position than those who have no access to these programs.

The adequacy of income support

In order to see how the current public pension system treats individuals as distinct from families, the reader is encouraged to refer back to Table 5. The difference between the level of public pension support for single individuals and the level for married couples has attracted a lot of attention, with the view of many people being that the difference is too large. The living costs of a single person may be as much as 70 to 80 per cent of those of a married couple, and yet the pension benefits of a single person are about 55 per cent of those of a married couple. An argument frequently made is that if married couples' benefits were significantly reduced, there would be incentives for elderly couples to separate and apply for single persons' benefits. To prevent these artificial incentives, some compromise may have to be tolerated, but the financial difficulties that current benefit levels create for single pensioners are readily apparent.

A further sense of the adequacy or inadequacy of these levels of income support can be gauged from the final column of Table 5, where the retirement incomes of the various types of recipients are expressed as percentages of the low-income cut-offs. In all cases the income support from public sources for couples exceeds the poverty line. And in all cases the income support for individuals falls short of the poverty line.

Where do these numbers leave one in terms of the pension debate?

On the one hand the impression conveyed by the data is that the elderly do on average have significant amounts of non-public pension income available to them. Many work and many receive investment income. On the other hand, there is undoubtedly a population segment among the elderly that is almost totally dependent on public pension income. Many of these people are single females who find themselves in relative if not absolute poverty.

If, on income support or pure redistribution grounds, it is deemed desirable to provide further aid to these single elderly, how should this be done? It is on this issue that the ideological aspects of the pension debate come to the fore, both across the society in general and within the Ontario Economic Council. Some argue for a universal increase in benefits, a step that would of course bring up the benefits of those beneath the poverty line. Some have argued for homemakers' pensions, in part because single females, frequently widows, constitute a large proportion of the single individuals who fall below the poverty line. Others argue (in part on the basis of ensuring that the overall level of public support to the elderly achieves its primary goal of income redistribution while maintaining overall costs at an acceptable level) that universality is too expensive and that any additional funds must be directed to those who need them the most.

There is likely to be no consensus on this issue, either within the Council or within Canada. However, the following statement is true, as a matter of fact, irrespective of ideology: The least-cost method of bringing single individuals up to an adequate income level, and the method that is most consistent with the 'pure redistribution' approach to the public pension system, is via an income-tested top-up. The only income-tested vehicle under the current arrangements is GIS.

This issue of income adequacy and the range of alternatives that can be brought to bear on it will be a major subject of the remainder of this document.

Income Support and the Elderly: Council Summary Observations

- Many of the elderly receive substantial non-government income (in the form of earned income, investment income, and private pension income) and many have accumulated substantial wealth.

- Nonetheless, there are also substantial segments among the elderly that are almost totally dependent on government income support.

- The use of Statistics Canada's low-income cut-offs as a guide (difficult to interpret as they may be) suggests that the public pension system is far more generous to the married elderly than it is to the single elderly.

- The public pension system provides support for married couples that is in all cases above the low-income cut-offs (Table 5). In all cases, the support for single pensioners provided by the public system is below these cut-off levels.

- The majority of these single pensioners are women.

- Within this category of low-income single persons there may still be many with adequate living standards. There is simply not enough information available to construct an overview position of the living standards of the elderly that would take into account such things as home ownership, access provided by various provincial governments to renter-assisted accommodation, etc.

8
Income Replacement and the Elderly

The nature of the issue

The previous chapter dealt with what might be called the pure redistribution function - the notion that the elderly should be guaranteed some minimum level of income. The focus of this chapter is on the 'pure pension' argument, namely that the pension system should enable a majority of Canadians to maintain a standard of living after retirement more or less in line with that enjoyed prior to retirement. The relationship between post-retirement income and pre-retirement income is frequently referred to as the replacement ratio.

It is important to recognize the difference between adequate income support, somehow defined, and adequate replacement ratios, again somehow defined. For the lowest income decile of the elderly, the replacement ratios would normally be well over 100 per cent, i.e., the post-retirement living standard would be above their pre-retirement standard. However, these same people (whether individuals or couples), despite having replacement ratios in excess of 100 per cent, could well have incomes that were still beneath the poverty line.

On the other hand, it is almost surely the case that some individuals or families in the highest income decile of the elderly, while well above any poverty floor, have replacement ratios well below 100 per cent. Most Canadians would probably agree that the fact that the highest income decile of the elderly have less than 100 per cent replacement ratios should be of little concern to governments: they are clearly able to look after themselves.

The critical issue thus becomes whether or not governments ought to be concerned about replacement ratios and, if so, over what range of incomes this concern should be exercised. Cast somewhat differently, the issue reduces to the question of whether individuals should be free to choose between current consumption and saving for retirement. In the pension debate this issue has in large measure crystallized in terms of an expansion in mandatory pensions - those who believe in requiring adequate replacement ratios are in favour of an expanded CPP (or equivalent). That there is no agreement on this issue is surely an understatement. As the Green Paper notes,

> There is clearly no consensus among Canadians on this issue. The Governments of Ontario and British Columbia - as well as the nine business organizations which issued the 'Business Consensus on Pension Reform' in August 1982 - have suggested that no expansion of mandatory pensions is required at this time. On the other hand, the Canadian Labour Congress and the National Action Committee on the Status of Women have called for a significant increase in the size of the Canada and Quebec Pension Plans. (p. 35)

To this one might add the recommendation of the Report of the Royal Commission on the Status of Pensions in Ontario (The Haley Report), which called for a mandatory system of 'private' pensions.

One of the problems involved in assessing this aspect of pension reform is the lack of reliable data on income replacement rates. Surprisingly, there have been only limited attempts to construct estimates of replacement ratios, and where estimates have been attempted they have typically taken only public pensions into account.

International comparisons

One source of income replacement data is a recent study by Hart Clark of the federal Department of Finance.[1] The study compares and contrasts the public pension systems in several industrialized countries. Table 14 reproduces Figures 1 through 3 from the Clark paper. Note that the Table compares public pensions with gross earnings. Our later analysis will use after-tax earnings in its estimates of replacement ratios.

Consider first the middle column of Table 14. The comparison here relates to a one-earner couple with average earnings (presumably some equivalent of the average industrial wage) throughout their work years. The bracketed figures for Sweden, Canada, and the U.K. relate to the provisions that will prevail when these countries' public pensions mature. Canada's 'gross' replacement ratio will then be just under 60 per cent. Only France (with 73 per cent) and Sweden (with 88 per cent) have plans that are substantially more generous.

TABLE 14
Public pensions as a percentage of pre-retirement gross earnings, 1977

Country	Percentage of earnings replaced for one-earner couples earning		
	Half of average wage	Average wage	Twice average wage
Sweden	108 (116)	80 (88)	52 (59)
France	73	73	35
United States	82	62	33
Switzerland	85	60	36
Netherlands	120	60	28
Canada	100 (101)	53 (57)	22 (26)
United Kingdom	70 (83)	33 (55)	17 (33)
West Germany	50	47	27

NOTE: Figures read off chart and may not be exact. Bracketed figures refer to estimated percentages when public pensions are 'mature'.
SOURCE: Hart Clark (1980) 'A comparison of the retirement income systems of Canada and other countries.' In Task Force on Retirement Income Policy, The Retirement Income System in Canada (Ottawa).

The first column presents a similar comparison for one-earner couples earning one-half the average earnings over their working lives. Canada's gross replacement ratio is 100 per cent, somewhat behind the 120 per cent in the Netherlands and the roughly 115 per cent in Sweden. However, it is well ahead of the low-80s replacement rates in countries such as the U.S. and the U.K. and far ahead of the 50 per cent ratio for West Germany.

Canada fares worst among these nations when it comes to gross replacement ratios for one-earner couples earning twice the annual average earnings (see the final column of the table). Note, however, that except for Sweden, no country replaces more than 36 per cent. It is important to recognize that what we are talking about here is an income level, in 1982 terms, of some $40,000 per year. Persons in this income category are likely to have made use of RRSPs. The Clark paper does not include RRSPs in the comparison. Nor does it take occupational plans into account.

TABLE 15
Social security payroll tax rates, January 1979

Country	For old age, disability, and survivor insurance			For all social security programs		
	total	employee	employer	total	employee	employer
			(% of payroll)			
Austria	19.5	9.25	10.25	29.4	13.4	16.0
Belgium	14.0	6.0	8.0	33.6	9.7	23.9
Canada	3.6	1.8	1.8	6.8	3.1	3.7
West Germany	18.0	9.0	9.0	35.0	16.5	18.5
France	12.9	4.7	8.2	51.4	11.3	40.1
Netherlands	19.0	11.9	7.1	50.8	23.7	27.0
Norway	24.7	8.2	16.5	24.7	8.2	16.5
Sweden	20.3	-	20.3	35.3	-	35.3
Switzerland	9.4	4.7	4.7	15.4	5.4	9.9
United Kingdom	15.3	6.1	9.2	16.5	6.5	10.0
United States	10.2	5.1	5.1	12.3	6.1	6.1

One final international comparison with respect to public pensions is appropriate, namely the rates of payroll taxes across these same nations. These appear in Table 15. Clark makes the following comments on this table:

> It should be noted that, in the case of the old age, disability and survivor benefits, tax rates run from a low of 3.6 per cent of payroll in Canada to a high of 24.7 per cent in Norway. The rate in Canada is by far the lowest of all the countries shown. Canada's total payroll taxes for all social security programs as a percentage of payroll of 6.8 per cent is also significantly lower than that in all the other countries shown, comparing with the high of 51.4 per cent in France. This is a reflection of the fact that a much higher proportion of social security programs in Canada is financed from general revenues rather than from specially earmarked payroll taxes.[2]

It is true that Canada's plan is not fully matured as yet and that, as noted above, increases in contribution rates will be required. As Clark points out, this is also the case for some of the other countries. It should also be noted that some of these countries have a greater proportion of their population in the elderly category. Nonetheless, the point is rather clear that the financing in Canada of public pensions in particular and social security in general tends to be more progressive than it is in these countries, although a thorough analysis of this point would require an evaluation of the incidence of the countries' existing tax systems compared with the incidence of payroll taxes.

A look at 'net' income replacement rates

The Clark study provides a valuable comparison of public pension systems in Western countries. However, caution should be exercised in interpreting the replacement rates for Canada reported in Table 14.

At first glance, the figures in Table 14 seem to indicate that middle and upper income-earners in Canada experience a drastic drop in their living standards at retirement. But several adjustments to the income replacement rates presented in Table 14 are necessary before any final judgment can be made on how the retirement and pre-retirement lifestyles of Canadians compare.

First of all, the appropriate basis for comparing retirement and pre-retirement incomes is not gross incomes, but after-tax (or disposable) incomes. On an after-tax basis, replacement rates rise considerably. Our estimate is that a one-earner couple living in Ontario and earning the average industrial wage would have achieved an (after-tax) income replacement rate of 80 per cent had they retired in 1982 and received no income other than public pensions. The comparable percentage for a single person is 54 per cent. These data appear in Table 16.

However, very few of those who earn the average wage retire with no sources of income apart from public pensions. This is made clear by the data on private pension coverage presented in Chapter 7. If we assume that the average wage earner receives the average private pension on retirement, the (after-tax) income replacement rate of our hypothetical one-earner couple rises to 96 per cent. For single persons the comparable ratio is 75 per cent and for two-earner couples it is 73 per cent.

If to these figures we add the annual average of other retirement savings (excluding equity in housing), the replacement ratios for single,

TABLE 16
A comparison of replacement rates

	Estimated replacement rates			
Hypothetical cases	Public pensions[a] ÷ pre-tax earnings	Public pensions ÷ after-tax[b] earnings	Public and private pensions[c] ÷ after-tax earnings	Pensions & investment income[d] ÷ after-tax earnings
Single person earning AIW[e]	40% (40%)[f]	52% (54%)	71% (75%)	86% (90%)
One-earner couple earning AIW	61% (63%)	78% (80%)	94% (96%)	106% (110%)
Two-earner couple both earning AIW	35% (37%)	46% (49%)	69% (73%)	84% (88%)

[a] Public pensions includes Ontario Tax Grants.

[b] Both pre-retirement and post-retirement income are computed on an after-tax basis.

[c] The 1979 average pension of $3,970 has been assumed in this case.

[d] (1976 investment income as a percentage of total income) x (1981 median income for those 65-69) = $2607 has been used as a 'best guess' in this case.

[e] AIW refers to Average Industrial Wage.

[f] Bracketed figures refer to percentages that would be achieved if Year's Maximum Pensionable Earnings = AIW, as it will in a few years' time.

one-earner families, and two-earner families become 90, 110, and 88 per cent, respectively. Note that the benefits associated with such further government supplements as free health insurance, free drugs, and subsidized housing are excluded from the table.

It is possible to challenge the figures in the last column on the grounds that they fail to also consider investment income people may receive before they retire. But these figures are relevant if by a replacement ratio we mean a comparison of the total income after retirement with level of earnings prior to retirement.

The figures in Table 16 may be eroded over time to the extent, say, that private pension income is not indexed for inflation or is not of a joint-and-last-survivor nature. However, it is also important to note that the Table 16 data do not take into account life insurance benefits, which are a substitute for survivors' benefits.

What constitutes an adequate replacement ratio is in part a value judgment, just as is what constitutes a 'poverty line'. However, when replacement ratios, appropriately calculated, approach or exceed 100 per cent, as Table 16 indicates they do, then the issue of income replacement loses much of its appeal as a rationale for substantial pension reform.

These replacement rates refer to individuals and family units earning the AIW (average industrial wage). *Replacement ratios rise for those with lower earnings*. Indeed, since the public pension system provides over $12,000 per year in support for an elderly couple, the *gross (pre-tax) replacement rate from the public system alone would be well over 100 per cent for a one-earner couple employed at one-half the AIW*.

These data do not mean that *all* Canadians earning the AIW will have the replacement rates shown in the final column of the table. Some will have considerably higher ratios and some will have lower ones (but they cannot fall below the ratios in the second column). In particular, women are likely to have lower replacement ratios than men, since their lower coverage and their work patterns will likely reduce the value of any defined-benefit private pension. More on this in Chapter 14.

However, the figures in the table do indicate that the various components of savings and retirement income vehicles in general provide the average Canadian with sufficient opportunities to generate full replacement. Moreover, with roughly 2 million persons now contributing to RRSPs (see Table 6), access to adequate replacement income will surely be enhanced in the future.

These data run counter to the popular notion that replacement ratios are woefully inadequate and ought to be assigned a high priority in pension reform. However, they *are* broadly consistent with an earlier study of replacement income undertaken for the C.D. Howe Research Institute by Professors Denton, Spencer, and Kliman. It concludes:

> Our findings confirm the widely held view that average incomes decline after 65, but we have also concluded, from comparisons of the income positions of cohorts over time, that the average income level deteriorates much less at the time of retirement than is commonly thought to be the case. When account is also taken of the fact that average family size (and hence the number of dependents) falls as the head approaches retirement and continues to fall thereafter, it appears that income levels associated with the early period following retirement have been sufficiently high in recent years that the typical family may have experienced, at least initially, little change in its pre-retirement lifestyle.[3]

Surely, the burden of proof that income replacement is a widespread problem ought to lie with those who are utilizing the issue as a basis for pension reform, e.g., those who argue for an expanded CPP in order to 'correct' the system for its present inadequate replacement levels.

The elderly vs. the working poor

It is useful at this juncture to raise an issue that ought to be, but unfortunately is not, in the forefront of the pension debate, namely the position of low-income Canadians pre- and post-retirement. For many Canadians, particularly married couples, the mere fact of becoming 65 and qualifying for the public pension system represents a small bonanza in terms of their standard of living. How should the overall income-support system treat people pre- and post-retirement? How do the working poor fare in terms of the support levels for the elderly? Again, these questions are not being addressed in the current discussions about pensions. Unfortunately, this study too will have to ignore them. However, the Ontario Economic Council has recently published a monograph on the subject of the working poor by Derek Hum of the University of Manitoba (Federalism and the Poor 1983), and we shall address this issue in more detail in our 1984 conference devoted to federal-provincial financial relationships.

Conclusion

The purpose of Part II of our document has been to survey the existing pension arrangements, private and public. In general we have shied away from making recommendations in this section, leaving this to Part IV below.

The next section of our document (Part III) outlines the Green Paper's reform proposals. Part IV will evaluate these proposals.

Income Replacement and the Elderly: Council Summary Observations

- Canadians should have the opportunity to provide for adequate income replacement on retirement.

- Adequate income replacement is not the same thing as adequate income support. Income replacement ratios for low-income workers could exceed 100 per cent and still leave such workers below a generally accepted poverty line. Similarly, high-income elderly may have adequate income support even if their income replacement ratios are well below 100 per cent.

- The issue is, in part at least, whether governments should require Canadians to achieve specific replacement ratios or whether Canadians should have a choice between current consumption and retirement income. At one extreme, this issue boils down to the question of whether pension reform should incorporate a mandatory expansion in universal pensions in either the private or public system.

- In terms of 'gross' replacement ratios, the Canadian public pension system compares very favourably with those of other countries for persons earning one-half of the average industrial wage (AIW). Canada's public pension system generates progressively lower gross replacement ratios, relative to other nations, as pre-retirement earnings levels rise.

- Replacement ratios, calculated appropriately (that is, in terms of disposable income), are higher than is generally perceived. Indeed, on average, most Canadians earning the AIW (whether individuals or single- or double-earning couples) can come close to or even exceed

100 per cent replacement. Replacement ratios rise for persons earning less than the AIW.

To be sure, replacement rates in the area of 100 per cent may not be available to all Canadians. The question is whether on grounds of fairness or some other criterion this situation requires a mandatory expansion of the public pension system.

Part III
Pensions: The Reform Agenda

9

The Green Paper Proposals

Introduction

With the existing arrangements as a backdrop, we shall now address the major issues in the pension reform debate. The role of the present part of this document is to outline and classify the various strands of the reform agenda. In order to get the various topics on the table, we shall for the most part accept the Green Paper's definition of the issues. However, in addressing these issues in the remainder of the document, we shall adopt our own strategy with respect both to the significance we attach to these various proposals and to the manner and order in which we deal with them.

The principles underlying the Green Paper

Three principles underlie the Green Paper reform proposals:

- Pension policy should guarantee a basic income for those without resources of their own. This is the income support objective.
- Pension policy should assure fair opportunities for Canadians to provide for their retirement years. This is the fairness objective.
- Pension policy should strive to enable Canadians to avoid a serious disruption in their living standards upon retirement. This is the income replacement objective.

We shall now detail the specific proposals that the Green Paper has included under these general headings, again without much comment at this juncture as to whether the Council accepts these proposals as appropriate.

The income support objective

The Green Paper identifies only one issue under this general heading, namely that the retirement incomes of some segments of the elderly, particularly the single elderly, are too low. The Council acknowledges this problem, and indeed it was highlighted in our overview of the status quo.

The fairness objective in the accumulation of pension assets

The bulk of the Green Paper's proposals and concerns fall into this category, although it can be argued that much of what appears below could just as appropriately have been classified under the previous heading. Included under the rubric of ensuring fairness in the private pension system are the following points:

- inflation protection for occupational plans;
- earlier vesting;
- increased portability;
- fairer access to tax assistance;
- better protection of spouses, including the removal of sex discrimination in pension benefits under money-purchase plans;
- compulsory coverage for all employees where pension plans do exist;
- greater disclosure of information to plan members; and
- greater protection in the event of plan termination.

The most novel proposal for private pensions is the device referred to as the Registered Pension Account (RPA). It is via this vehicle, a close relative of the existing RRSP, that many of the proposed private pension reforms would be accomplished. We shall focus in some detail on this initiative and on most of the other proposals above as well.

In regard to 'fairness' in the public pension area, the Green Paper focuses on the following issues:

- ensuring that maximum pensionable earnings equal the level of the average industrial wage over the next three years;
- implementation of the child-rearing dropout provision;
- termination of survivor benefits on remarriage;
- credit splitting between spouses;

- post- and pre-retirement survivor benefits;
- disability benefits.

An issue that was not highlighted in the Green Paper but that has been prominent in the hearings of the Parliamentary Task Force and in the report of the CPP Advisory Committee is the proposal for homemakers' pensions. This too will be addressed.

The income replacement objective

There is surely general agreement that the pension system should give individuals the opportunity to put away enough income for retirement to prevent a serious disruption in their living standards. The pension reform issue highlighted in the Green Paper is whether achieving this goal requires a mandatory expansion in pension arrangements and, if so, whether such expansion should be undertaken in the private sector or the public sector.

An overview of our approach

As we have indicated, we accept, in general, the Green Paper's assessment of the pension reform issues. Some of us would add to the Green Paper's list. For example, to the Green Paper's three principles one could add such items as the fiscal implications of pension reform and the appropriate age of retirement. However, the principles put forth are broad enough to easily accommodate these additional concerns. Thus, not much of substance is to be gained by challenging the Green Paper's perception of the range of issues embodied in pension reform.

As is clear, this is a very full agenda. Moreover, for some of the major issues, such as the provision for inflation protection and the proposals for spousal benefits, the review of existing arrangements in Part II has not provided an adequate background. Thus, as part of the evaluation and analysis we shall on occasion have to fill in some background.

In making our evaluation, we shall deal first with the most contentious area - the role of the pension system in ensuring a close relationship between pre- and post-retirement incomes. It is only by coming to grips with this major issue that we can address most of the remaining issues. This is so because a mandatory expansion of either the public or the private pension system would have very different implications for some of the other critical areas than would an absence of compulsory expansion in the CPP or in private pensions.

There is no unanimity on this important issue among the members of the Council. The most that we can do is to report where the majority of our members stand with respect to a compulsory pension expansion. To anticipate the analysis, most of the Council is against compulsory expansion. However, the analysis will attempt to put forth both sides of the argument and will even go as far as to suggest the type of compulsory plan that we would prefer, if such a plan is in the cards.

If a position is taken against compulsory expansion, the task then becomes a matter of coming up with a set of reform proposals that will address some or most of the problems with the current pension arrangements. Not surprisingly, consensus is frequently lacking here, too, and on occasion about as far as we can go is to present the issues on which we are divided.

In discussing private pension reform, we shall devote separate chapters to the inflation protection issue, the proposal for RPAs, and the proposals for increased access (e.g., coverage, vesting, portability). With reference to public pensions, the bulk of the analysis will focus on the proposals relating to spouses, including the proposal for homemakers' pensions. There will also be a chapter entitled 'Pensions, Savings, and Capital Markets', which will focus on some of the critical macroeconomic issues that are at stake in the pension debate.

Once we have addressed these issues, we shall direct our attention to the first of the Green Paper's concerns, namely the problem of providing adequate income support levels for the current elderly. The cost-effective way of handling this problem is via an increase in an income-tested program such as GIS. However, this solution runs up against the ideological issue of whether universality or selectivity should dominate the delivery of income support for the golden agers. We shall discuss the pros and cons of the universality question and then propose alternative ways of addressing the income needs of the elderly. Since some of these alternatives represent a substantial break with the status quo, they are offered as proposals worthy of further public discussion rather than as consensus recommendations of the Council.

The final substantive chapter of the section dealing with the pension reform proposals returns to the financing question. Should the provinces be required to repay their indebtedness to the CPP? Should CPP contribution rates rise in order to minimize the impending intergeneration transfer? These issues are closely intertwined with an important issue that is not really discussed in the federal document, namely the rather controversial question of the appropriate age for retirement and the implications of different retirement ages for the overall costs of operating public pension systems.

Part IV
Pension Reform: Evaluating the Proposals

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Mandatory Pension Expansion: An Evaluation

Introduction

The call for an expansion of the mandatory pension system has come from many quarters. As noted earlier, the Canadian Labour Congress and the National Action Committee on the Status of Women, among other groups,[1] have recommended a significant increase in the CPP, generally a doubling of the maximum benefit to 50 per cent of average industrial wages from the current 25 per cent. There are also those who call for a mandatory increase in private sector plans: the PURS proposal of the Ontario Royal Commission is a compulsory money purchase plan which, when combined with the CPP/QPP, would also deliver 50-55 per cent of replacement of earnings up to the average industrial wage. Other groups go even further: the Lazar Report (the report of the Federal Task Force on Retirement Income Policy) considers the option of expanding the CPP/QPP to replace 40 per cent of career average earnings up to one and one-half times the average industrial wage.

The proponents of these measures for reform voice several concerns. One of these is that, in the absence of such an expansion in mandatory arrangements, incomplete coverage by employer-sponsored plans means that many Canadians may suffer declines in their standard of living in moving from work to retirement. A second concern is the situation of those current elderly who receive inadequate income support. For example, some advocates of the expansion of the CPP argue that the increase in benefits should be retroactive, at least in part. And the advocates of private sector expansion sometimes recommend accelerated contribution rates for older labour force members so that full benefits accrue earlier. We shall address these issues at some length in this chapter. Before we do so, however, it is appropriate that we outline the Council's own thinking about the priorities in the pension debate.

The Council's priorities

In order to evaluate these and other proposals, the Council has had to take a position as to the ordering of the various pension reform goals. There is no question about the primary and immediate goal: enhanced income support for those elderly currently most in need. The second goal, in terms of priority, is a modification of the existing pension relationships such that those working at or below the average industrial wage will be provided with greater access to, and incentives for, retirement saving. This objective involves the provision of greater coverage, earlier vesting, enhanced portability, and easier access to pension devices such as RRSPs and RPAs. Obviously, one method of achieving this objective would be a mandatory expansion of public and/or private plans. Our third pension objective is to ensure that mechanisms exist sufficient to provide all Canadians with access to a level of retirement income that maintains a reasonable relationship to their pre-retirement income. However, when it comes to persons who earn an income at the average industrial wage and above, a majority of Council members question the need for government intervention, particularly of a mandatory nature, to provide for retirement needs. The replacement income tables in Chapter 8 indicate that many of these Canadians will in fact find themselves with more disposable income in retirement than in pre-retirement, and where this is not the case the issue becomes one of assessing whether the situation should be redressed by private sector pension reform or by compulsory expansion of either private or public pensions.

While the Council endorses the principle that Canadians ought to have the means to maintain their living standard in retirement, the Council believes that the appropriate role for government, particularly with respect to those earning the average industrial wage and above, is to ensure that the availability of support is adequate and not necessarily to provide the support itself.

In terms of our own priorities, then, the issue becomes: Is a mandatory expansion of the CPP or some equivalent measure necessary in order to provide access to adequate income replacement or adequate income support?

The case for an expanded mandatory system

In spite of our concerns, the arguments for an expanded mandatory system can be quite persuasive. Consider, for example, the rationale for an expanded CPP put before the Parliamentary Task Force by Kealey Cummings, National Secretary-Treasurer of the Canadian Union of Public Employees. The following are the advantages he attributes to an expansion of the CPP/QPP:

> first, complete portability anywhere in Canada;
>
> second, universal coverage of all workers, regardless of age, years of service or type of employment;
>
> third, immediate vesting of all periods of work;
>
> fourth, full indexing to the CPI;
>
> fifth, it is consistent with our tradition of defined benefit plans, thus allowing stacking or integration with employer-sponsored plans;
>
> sixth, it provides for a mechanism to exclude periods spent outside the labour force such as in the care and raising of younger children and elderly or disabled relatives;
>
> seventh, benefits can be phased in rapidly and retroactively, thus accomplishing income maintenance and anti-poverty objectives simultaneously.[2]

The first three points could be incorporated in a mandatory private sector expansion as well as in a compulsory expansion of the CPP. However, the remaining four points are probably easier to accommodate under a public sector expansion.

Full indexing to the CPI is easily accomplished through a public plan - benefits are simply indexed and matched by an appropriate adjustment in contribution rates. However, as was pointed out in Chapter 2, many of the government plans that embody indexing are substantially underfunded. Indexing of benefits is more tricky in private plans, particularly defined-benefit plans. Presumably it would require that the retiree purchase a real-term or inflation-indexed annuity. The availability of such annuities would likely be enhanced if the government issued indexed debt for this purpose. This general subject of inflation protection under private and public plans will be dealt with in more detail in a later chapter.

Item six refers primarily to the 'child-rearing dropout provision' whereby contributors would be entitled to drop from their contributing period those years spent out of the labour force raising children under seven years of age. In effect, these years of nil or low earnings would not result in a reduced CPP retirement pension. This dropout provision is already part of the QPP. And with Ontario giving its approval recently to the measure, it will now be incorporated in the CPP. There is no question that measures of this sort, which are probably closer to being 'pure-redistribution' than 'pure-pension' measures, can be accommodated much better within a public system than a private one.

Full integration of an expanded CPP within an existing defined benefit program could also be accomplished quite easily (although, as noted later, it would generate substantial subsidies to the current generation at the expense of future generations). Moreover, the integration of the existing CPP was frequently accompanied by a lowering of liabilities for the plan sponsor. A compulsory money purchase plan would be integrated in terms of contributions, but not in terms of benefits, since the benefits would be a function of the performance of the fund. Background research by Lawrence Ginsberg suggests that the rate of return on CPP assets averages roughly 2 percentage points below the return on QPP assets, which in turn is at least 3 percentage points less than the average return on private pension funds. Differential rates of return of this size compounded over a forty-year period (i.e., over a working life) would have an enormous impact on retirement pensions.

The seventh enumerated advantage of an expanded CPP addresses the joint concerns of income replacement and income support. With respect to the latter, it is certainly the case that a public sector pension system can make benefits retroactive, whereas this is not possible under a money purchase plan where all benefits are 'earned'. Even with retroactive benefits, however, an expanded CPP could not help the current single elderly unless all persons over 65 were deemed retroactively to have earned CPP entitlements. Under a money purchase private plan this problem would presumably be addressed via an increase in OAS or GIS. In fact, the difference between a CPP benefit conferred retroactively and an increase in GIS is one of degree and not of substance. Neither is 'earned' and both are determined on pure-redistribution rather than pure-pension grounds. Over time, it is true, more and more of the people who receive the expanded CPP benefits will in fact have 'earned' them. The parallel in a private system is that as more and more people retire with benefits, the amount they draw from GIS will diminish. Nonetheless, GIS payments tend to be lumped into the category of handouts, whereas the perception persists that CPP benefits are entitlements. This perception is clearly not accurate, as far as retroactive CPP measures are concerned.

Reservations about mandatory expansion

While not disputing that there would be some advantages to an expanded CPP, the Council also has some major reservations. First of all, it would not address the key issue in the pension debate: the status of the present single elderly. Whatever the benefits and costs of an expanded CPP, there would still have to be an expansion of GIS, or some equivalent, for certain groups. Indeed, it is important to remember that one of the reasons why GIS was introduced in the first place was to provide the then-current elderly with roughly the level of retirement income that would eventually accrue to mature CPP beneficiaries. The politics of pensions suggest that GIS too would be expanded if there were an increase in the CPP.

The second reservation has to do with the costs of such an increase. If we accept that the combination of maturation and demography imply an eventual rise in contribution rates from 3.6 per cent to roughly 10 or 11 per cent to finance the present CPP, a doubling of the CPP would suggest eventual contribution rates in the range of, say, 20 per cent of maximum pensionable earnings. This is an enormous taxation burden to transfer to the next generation, particularly when one realizes that the combination of OAS and GIS will generate at least equivalent costs, as will health care for the elderly. Moreover, the present federal budget deficit already requires a combination of substantial expenditure cuts, tax increases, or both to restore longer-term balance. Before Canadians saddled themselves with such a major fiscal commitment there would have to be a demonstrated and overwhelming need. While the Council recognizes the desirability of increasing replacement ratios for those who fall in the cracks, so to speak, and while it also recognizes the problems associated with certain other aspects of the pension regime, it does not feel that these difficulties are such as to call forth this level of fiscal commitment. If our economy returns to historical-average productivity growth, then more generous pensions may be affordable. The same would be true if demographic factors altered so as to leave the age distribution relatively unchanged. But it is far from clear that these events will transpire. Hence, the Council feels that it is most unwise to saddle future generations with a large but relatively certain tax burden when their economic circumstances will be anything but certain.

There is another strong argument, in the Council's opinion, for not mandating an expansion of public pensions. This argument, like the last, assumes that the financing of an expanded CPP would be on a pay-as-you-go basis. What this means is that current workers would receive a substantial 'free ride' in the sense that they would qualify for full pension at contribution rates that would be much lower than the rates for future workers, who would be contributing to a mature plan. Evidence from Chapter 4 indicates that at present contribution rates even a worker who retires in 2008 after 42 years under the CPP will have provided, with his employer, only 52 per cent of the actuarial value of his CPP pension. If our examples of replacement rates are in the ball park, this means that many workers who have access to earnings well above the average industrial wage and/or will have replacement ratios in excess of 100 per cent would be passing to the next generation the lion's share of the financing for their benefits under an expanded CPP. Such an intergenerational shifting of the pension burden is surely inappropriate, since this segment of the work force is able to provide for its own retirement.

There is a second aspect to the issue of who would benefit from an expanded CPP. Much of the argument for a mandatory expansion of the public system relates to the provision of larger pensions for low-income workers. However, these are precisely the people least likely to benefit from an expanded CPP. It might increase their pension retirement income, but it would likely do so at the expense of their current income. Employers faced with, say, a 10 per cent payroll tax under a mature and expanded CPP would surely extract some or all of this from the overall pay package. And as far as overall (as distinct from CPP) income for retirement is concerned, there might be little net benefit for low-income earners because of the tax-back rates associated with GIS and GAINS. Thus, it would appear that, under existing arrangements at least, the benefits from an expanded CPP would accrue proportionately more to those who need it least.

One way to counter this point is to argue that the financing of an expanded CPP need not be done exclusively via a payroll levy. Some of the expansion, or all of it for that matter, could be financed from general taxation. The mechanics of funding an expanded CPP are not often fully addressed, so that it is entirely possible that some proponents have in mind a funding scheme that is more progressive than a payroll tax.

A more progressive funding scheme would incline an expanded CPP toward a pure distribution as opposed to a pure pension approach, in which case it would be appropriate to evaluate it in relation to alternative pure distribution approaches to securing income support and replacement. However, as Table 15 in Part II illustrates very clearly, Canada presently finances its social security programs in a more progressive manner than its major trading partners. There is danger in going too far down this road. The next generation may be faced with an exceedingly high tax bill for the retirement system. Although the public pension system is essentially non-contractual, in that present governments cannot bind future governments, any implicit contract will become more binding (in a moral sense) on future generations if there is a perception that individuals have 'contributed' to their retirement pensions. The Council puts considerable weight on the proposition that the alterations in pension arrangements that are to be preferred are precisely those that will prove acceptable to future generations of taxpayers. Thus there may be limits on the degree to which it is appropriate to depart from the perception, let alone the reality, that future pension benefits have indeed been 'earned' by contributions.

Full funding as an option

To some degree, the above arguments suggest that if mandatory expansion is in the cards, the most appropriate way to implement it might be in terms of a fully funded scheme. With respect to equity concerns - the intergenerational aspect as well as the transfer from today's well-off to tomorrow's less well-off - a fully funded system would be more acceptable.

However, it is important to be clear about what we mean by a fully funded approach. The existing CPP is only partially funded. There is considerable question about whether it is appropriate to view the provincial indebtedness as a fund. The Council is very concerned about the diversion of any future pension monies into the coffers of government, provincial or federal. We are aware that there are pressures for any excess of annual contributions over benefits of an expanded program to accumulate to the federal government rather than to the provinces. This is in part why the proposed mandatory expansion of the public pension system is often referred to as CPP II in order to differentiate it from the existing CPP. Indeed, the fact that disability pensions appear to fall under provincial jurisdiction and, therefore, could not be incorporated in a federally run scheme, may be why the federal minister of Health and Welfare is currently proposing to separate the treatment of disability from the pension package:

> The provinces and I are studying right now a possible new national scheme to replace all the sources of income for the disabled by a national disability insurance, or something like that. So if that happens, it would get out of the CPP.[3]

We hasten to point out that in principle we agree with this recommendation, but for reasons that will be developed in a later chapter.

In short, the Council is against utilizing any future pension surpluses to meet current fiscal needs. To divert a pension fund to service the general revenue needs of government at any level does not enhance fiscal planning, nor does it ensure an adequate and fair return to either pension contributors or beneficiaries.

To continue with the assumption of this section, namely that a mandatory increase in pensions is in the cards, the majority of the Council are of the opinion that the investment decisions of all such public funds should be made under the authority of an investment board composed of representatives of labour, management, and both levels of government. Better still, any compulsory expansion would take place within the private pension system, utilizing the vehicle of RPAs (discussed in Chapter 12).

While we recognize the merits of a mandatory expansion of the pension system, the Council is against any such compulsory expansion, even if it were to take place within the private pension system. However, we shall return to the issue later in the document, particularly in the context of ensuring greater coverage for women. We also recognize that to take this position places considerable responsibility on us to suggest acceptable alternatives - alternatives that will enhance the quality and quantity, as it were, of the existing system. This is the purpose of the remainder of the document.

Mandatory Pension Expansion: Council Summary Observations

- The Council's priorities in pension reform are: first, enhancing income support for those elderly currently in most need; second, ensuring that workers at or below the average industrial wage have increased access to, and incentives for, retirement saving; third, ensuring that all Canadians have access to adequate retirement savings vehicles, so that post-retirement income will maintain a reasonable relationship to pre-retirement income.

- A mandatory expansion of the CPP/QPP or the private system would have some advantages. It would ensure greater coverage and portability than would non-mandatory private sector reform.

- However, a compulsory expansion of the CPP would also incorporate several critical flaws.

- An expanded CPP would not address our first priority, namely enhanced income support for those elderly currently most in need.

- While an expanded CPP would ensure coverage of some low income workers not currently part of occupational plans, because of the existing income-support delivery system these people are precisely the ones who would benefit from a CPP expansion least.

- An expanded CPP, partially funded, would transfer the bulk of the financing to the next generation of workers. Given current arrangements, this would in effect amount to a transfer to the presently well-off from future workers, both rich and poor.

- A fully funded CPP expansion would remove the above concern, but an investment policy geared to government debt or government priority financing would generate a rate of return to pensioners substantially below market rates. Over the recent past, the rate of return in the CPP 'fund' was 5 percentage points below the return on the average private pension plan. A compulsory expansion of the private system would earn market rates, but the Council does not feel that the current pension problems warrant this degree of modification and/or compulsion.

- Finally, an underlying motive for expansion of the CPP may be a desire to bring pension surpluses into the current budgeting process. Diverting a pension fund in order to service the general revenue needs of governments does not enhance fiscal planning, nor does it ensure an adequate and fair return to either pension contributors or beneficiaries.

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New Coverage Data: Age and Income Profiles

Introduction

As a prelude to an analysis of alternative approaches to improving various aspects of the current pension arrangements, it is important to focus in more detail on one crucial aspect of the existing system, namely the issue of coverage. The basic source relating to coverage is Pension Plan Coverage by Level of Earnings and Age, 1978 and 1979, published by the Federal Department of National Health and Welfare. The data reported below appear in a paper by D.S. Rudd in the background document and are based on a special set of computer runs provided by Health and Welfare subsequent to the publication of the above document.

Coverage: private and public sector plans

Table 17 presents data on private and public pension coverage for males and females cross-classified by age group and income class. The common denominator underlying the table is the set of people who contribute to the CPP. The percentages reported in the table relate to those CPP contributors who are also covered by other pensions, not including RRSPs. The income levels in the tables are for multiples of $7,500, which, in 1979, was roughly one-half the average industrial wage. Public sector plans include those covering civil servants, teachers, and college and university employees.

The following observations can be drawn from the table:

- For persons earning less than one-half the average industrial wage, coverage is rather low. This is particularly true for private sector plans, but public sector plans also reveal low coverage, e.g., 33 and 26 per cent for males in the 25-44 and 45-64 age groups, respectively.

TABLE 17
Pension coverage: pension plan members as a percentage of CPP/QPP contributors, 1979

A: Males: private sector plans

Employment income	Age of contributor 18-24	25-44	45-64
Less than $ 7,500	8.9	11.9	17.0
$ 7,500 - $14,999	18.5	39.4	57.2
$15,000 - $22,499	34.7	63.2	79.2
$22,500 - $29,999	29.0	73.2	89.7
$30,000 +	70.5	78.0	97.4

B: Males: public sector plans

Employment income	Age of contributor 18-24	25-44	45-64
Less than $ 7,500	6.3	32.7	25.9
$ 7,500 - $14,999	60.8	78.6	87.2
$15,000 - $22,499	96.1	95.0	92.8
$22,500 - $29,999	99.9	98.5	95.8
$30,000 +	*	96.8	99.4

C: Females: private sector plans

Employment income	Age of contributor 18-24	25-44	45-64
Less than $ 7,500	5.8	8.7	7.9
$ 7,500 - $14,999	32.0	46.1	53.1
$15,000 - $22,499	48.5	81.4	77.8
$22,500 - $29,999	*	69.8	62.5
$30,000 +	*	29.8	46.3

D: Females: public sector plans

Employment income	Age of contributor 18-24	25-44	45-64
Less than $ 7,500	20.9	37.8	23.9
$ 7,500 - $14,999	85.6	87.9	81.9
$15,000 - $22,499	92.3	95.6	96.6
$22,500 - $29,999	38.0	98.6	99.5
$30,000 +	*	97.0	97.7

NOTES:
* Insufficient cell data to report percentages.
$7,500 was approximately one-half the average industrial wage in 1979.

- Private sector coverage for the combination of the young age group (18-24) and the $7,500-$14,999 income category is low in absolute terms (18.5 per cent for males and 32 per cent for females) and relative to comparable public sector coverage (60.8 per cent and 85.6 per cent for males and females, respectively).

- For the 25-44 age group and for persons earning above the average industrial wage, coverage is near complete (above 90 per cent) for those employed in the public sector. Coverage of private sector workers is lower and generally in the 70-80 per cent range. For the 45-64 age group, private sector coverage ranges from 79.2 per cent to 97.4 per cent and compares more favourably with public sector coverage (92.8 per cent to 99.4 per cent).

- One disconcerting feature of the table is that female coverage in the private sector appears to peak in the middle income levels and in the middle age ranges. For males, coverage rises progressively as age and/or income increases. Because the role of women in the workforce has undergone such rapid change, it is not clear that 'point-in-time' coverage is an accurate reflection of what is likely to happen to the 25-44 female cohort as it ages. If its coverage rates do fall, then there is a serious problem.

- Apart from the above point, the coverage issue does not appear to be a male vs. female issue. For many cells in the table, females have higher coverage rates than males. However, this is somewhat misleading because there is a far greater concentration of females in those categories in which coverage for both males and females is low. Data for 1979 indicate that only about one-quarter of female full-time workers earned the average industrial wage or above. The comparable figure for males was roughly two-thirds. While there may indeed be occupational differences in the sense that females tend to be concentrated in occupations in which pension coverage is low, the evidence from Table 17 suggests that coverage for females rises dramatically once they move up the income scale. Thus it is legitimate to ask whether the problem is one of coverage (i.e., retirement income) or one of earnings (i.e., present income). The data in Table 17 suggest that if the latter increase, so will the former.

It is important to note that persons who have no group pension plan but who do contribute to an RRSP are not counted as being 'covered' for the purposes of Table 17. D.S. Rudd estimates that this applies to at least 7 per cent of the base group of CPP/QPP contributions. To this extent, it is likely that the coverage data for private plans in Table 17 understates overall coverage, particularly for those in the middle and upper age and income groups.

The Council recognizes that the data in Table 17 can be interpreted in various ways. For example, those who favour mandatory expansion of the CPP can use some of the low coverage ratios to buttress their position. While, as noted above, the Council is against mandatory expansion, we remain uneasy about some aspects of the Table 17 data on coverage. We shall return to this issue in Chapter 14.

It is instructive to look further into the very low coverage ratios for those earning less than one-half of the average industrial wage. It is here that the pure-pension and pure-redistribution aspects of the system interact. While it may be argued that it is appropriate that these persons be required to build up their retirement entitlements, this might be very costly to them. First of all, it is obvious that the real problem is their low earning ability. Some may be interested only in part-time work. For others the problem is more serious. In any event, compulsory membership in a plan would in all likelihood be reflected in lower take-home pay, i.e., it would amount to a very regressive tax and might reduce employment opportunities. Second, the accumulated entitlements of low earners would be worth very little, since it is precisely this group that runs into the large offset associated with GIS and GAINS. It is laudable to attempt to devise a system in which, in the steady state, all retirees would receive pensionable income rather than GIS. However, where such an attempt will break down is exactly with the group whose pensionable earnings are so low that reasonable entitlements cannot be accumulated. In short, a 10 per cent CPP levy against earnings, or a similar compulsory private pension deduction, represents a sizeable cut in take-home pay for these individuals and a very minimal increment (if any) in their retirement benefits.

In the Council's opinion, the type of assistance needed by this group is not increased pension coverage per se but rather increased employment and earnings opportunities via such things as skill upgrading. Moreover, if and when the earnings of people in this group improve and the incentives for retirement savings begin to turn in their favour, the Council feels that 'fairness' requires that they be allowed privileged access to tax-assisted devices such as RRSPs in order to make up for all those years when they were too poor to contribute. Such a proposal is incorporated in a later chapter.

Much the same applies to a large segment of the young age group. To the extent that young workers' job profiles reflect summer work or part-time jobs that they have taken in order to put themselves through university or community college, compulsory coverage may curtail their ability to finance an education.

To put the matter somewhat differently, the Council believes that the target group for pensions ought to be those persons 25 years of age and over with earnings equal to at least one-half the average industrial wage. The current CPP coverage minimum of $1,800 or so does not lead to the accumulation of any meaningful entitlements, especially under the present arrangements. On the other hand, it does serve to reduce the current income of low-income workers. If, as is likely, contribution rates will rise with unchanged benefit arrangements, the regressive nature of this tax will be magnified. Although we recognize that this is running counter to prevailing opinion, the underlying economic analysis leads us to suggest that in the overall interests of low income workers governments should consider raising the minimum annual income level at which the CPP becomes operative. In any event, most of the proposals that follow are geared to the target group just defined, although some of them may be of benefit to the young and the low earners as well.

New Coverage Data: Council Summary Observations

- Pension coverage is low for those aged 25 and under and whose earnings are less than one-half the average industrial wage, even under public sector plans.

- For those 25-44 and earning one-half of the average industrial wage or more, coverage increases dramatically, although for some cells the private sector coverage is well below that of public sector plans.

- The coverage problem does not appear to be a male vs. female issue per se. Overall, females have less coverage because so many of them are concentrated in low-income positions. The Council believes that public funds are better spent attempting to improve females' present income position than their future (retirement) income position. An improvement in the former will automatically improve the latter. However, the proposals in the remainder of our document should serve to increase coverage rates for males and females alike.

- The Council notes that the CPP may do very low income persons more harm than good. It decreases their current income and employment prospects and does little or nothing to increase their retirement incomes. If and when contribution rates rise, the regressive nature of this situation will be amplified. Accordingly, the Council feels that some consideration should be given to raising the annual income level at which people must belong to the CPP. Moreover, in Chapter 17 we shall suggest modifications to the present income support arrangements that would alleviate somewhat the regressivity embodied in the CPP.

- In general, the target group for pensions should be those persons 25 years of age and above with earnings at or above one-half of the average industrial wage.

12
Registered Pension Accounts (RPAs)

Introduction

The most novel proposal in the Green Paper is the provision for a new tax-assisted pension vehicle, referred to as a Registered Pension Account (RPA). The proposed characteristics of this new vehicle include the following:

- Taxpayers would be able to contribute to an RPA on a tax-deductible basis, much as they can now contribute to RRSPs.
- In addition, employers would be allowed to contribute to an employee's RPA directly on his or her behalf.
- Funds could normally be withdrawn only after retirement and in the form of an annuity. In other words, the funds would be 'locked-in'. Withdrawals prior to retirement would be allowed in specified circumstances, such as disability.

The Council believes that the RPA scheme has considerable potential. It could raise the quality of existing private pensions, increase the coverage of private plans, and, more generally, contribute to the achievement of all three of the principles underlying the Green Paper; i.e., adequate income support, fairness, and minimum disruption of living standards on retirement. Unfortunately, the promised federal government background document spelling out the thinking behind this new instrument in more detail has not yet been released. Nonetheless, we shall elaborate, largely on the basis of our background research by Ken Marchant, on the various implications likely to arise in connection with this new pension device and offer some recommendations for both design and implementation.

RPAs and expanded pension plan coverage

The RPA concept would play a role, perhaps a substantial one, in encouraging employers to make pension arrangements for their employees where these arrangements do not presently exist. Generally speaking, it is the small-business and the self-employed sectors that have been the most reluctant to establish pension plans for their employees. In large measure this is understandable: they would face relatively higher administration costs, since their plans would be on a small scale; they would face complexities in implementation, including, for example, the need to oversee many small retirement liabilities for terminated employees, especially if they have a mobile labour force; they may be concerned about the impact contingent pension liabilities would have on the financial health of the business; and if their labour force has general rather than specific skills, they have less of an incentive to invest in the retention of employees than do larger firms.

The RPA scheme addresses many of these problems and no doubt some others as well. Depending on the specific features of RPAs, the product offerings from the supply side of the market (i.e., from financial institutions, both existing firms and those arising in response to RPAs), would not only likely be quite broad and flexible but could probably be designed for the needs of specific firms. This would make maintaining a pension plan far more feasible, administratively and financially, for these small businesses. Since these plans would in effect be fully funded, money-purchase plans, there would be no future pension liability for the originating firms. Moreover, if a small business fell into financial difficulty or faced bankruptcy, its employees' pensions would be secure.

There would of course also be a few complications that would have to be ironed out. For example, if vesting were not immediate, some procedure would have to be implemented to ensure that the employee who left the firm before vesting would not also get access to the employer's contributions. The complication here is that, conceptually, the RPA is owned by and under the control of the individual. However, it should not be difficult to work out some satisfactory arrangement. In general, therefore, the Council believes that the RPA will lead to substantially enhanced pension coverage.

Improved portability

The RPA could also enhance the quality of existing private pensions. It could do this, for example, by improving portability. In addressing the role that RPAs would play in increasing portability, the Green Paper notes that the following options might be open to an employee who leaves an employer after becoming vested:

> Subject to certain adjustments related to the plan's funded status, the employee could:
>
> - transfer the entire value of the pension to his or her RPA
> - take a deferred pension at the normal retirement age by leaving the accumulated credits in the former employee's plan
> - transfer the value of his or her own contributions, with interest, to an RPA while taking a partial deferred pension by leaving the remainder of the value of the pension in the plan, if the employer agrees. As well, the employee could transfer the value of the accumulated pension to a new plan with the new employer's permission. (p. 29)

Since an RPA would be inherently a money purchase plan, portability would imply some effective and fair arrangements for the conversion of vested, defined-benefit entitlements to a money purchase form suitable for transfer to an RPA, presumably in cash. Thus there would be a potential liquidity requirement associated with existing pension plans, depending on the extent to which the terminating employee, as opposed to the employer, was able to influence the choice of portability options. To put the matter somewhat differently, were pension reform with respect to portability options to confer freedom of choice on the terminating employee, the result would likely be a severe disruption of existing pension plan arrangements.

This would likely be a genuine concern for existing pension funds, although some funds and/or administrators would be only too happy to transfer (at fair value) the scores of small deferred entitlements to RPAs. As we have said elsewhere in this document, the Council's position is that retroactive legislation with respect to existing contractual arrangements is not desirable.

Competition between RPAs and existing pension plans

If RPAs were made attractive enough, along the lines discussed below, they would be in fairly continuous and direct competition with registered pension plans (and, as noted above, they would put substantial pressure on employees with no pension arrangements to mount plans). Many of the existing defined benefit plans incorporate undesirable features, such as arrangements that entail a transfer from younger workers to older ones, with the former earning negative real returns on their contributions. With RPAs as an alternative and with financial institutions competing to establish RPAs for groups of employees, firms would be under considerable pressure to eliminate those features of existing plans that are seen as discriminatory. While it is important to remember that existing plans are often geared to the needs of the firm (e.g., keeping valued workers), and that a change in pension arrangements may be reflected in other components of the overall compensation package, the fact remains that the existence of RPAs as an alternative or adjunct to existing plans would likely increase the range and flexibility of pension alternatives within the collective bargaining context. It is hard to see how this would not lead to an improvement in occupational plans, both in the private and public sector.

Desirable features of RPAs

If RPAs are established, the Council feels that the following characteristics, drawn from our background research, should be associated with them:

- RPAs should be allowed to invest in a broad range of assets, and they should allow for self-administration (through a third party trustee).

- Multiple RPAs should be allowed. The Green Paper suggests that for 'administrative purposes' an individual be limited to one RPA. The Council feels that this is too restrictive. Keeping track of multiple RPAs is not administratively onerous in our progressively computerized age. More importantly, multiple RPAs would provide an individual with a greater opportunity to diversify his range of assets. It is possible that some intermediaries would provide a full range of asset choice, but multiple RPAs would encourage the establishment, and allow individuals to take advantage, of institutions specializing in certain types of RPAs. There is also the question of financial institution security. If an individual were constrained to one RPA, he would be unable to spread his institutional risk across several financial intermediaries.

- Consistent with the recommendation that multiple RPAs be permissible, the range of financial institutions allowed to offer and/or administer RPAs should be made as broad as possible.

- Frequent disclosure and performance appraisals should be required. They would apprise the contributor of his pension position and allow him to compare the performance of his RPA with the performance of similar plans.

RPAs and the concept of 'fairer access' to tax assistance

As noted above, one of the goals underlying the Green Paper is that of 'ensuring fairness in the accumulation of pension assets'. RPAs would likely serve this objective, since they would enhance coverage and portability. There is, however, another aspect of the fairness issue that is undoubtedly more controversial.

One way of phrasing the issue is as follows: should there be upper limits on the amount of pension assets that a taxpayer can deduct and defer under such vehicles as RPAs and RRSPs? The issue of upper limits on contribution levels is hinted at in the Green Paper, but the detailed federal intentions are to be revealed later in a separate document. Our background research paper on RPAs offers a conjecture that these forthcoming rules may provide for an annual contributions regime with some upward flexibility for higher earnings years, together with an overall limit on total contributions or accumulations. It further suggests that this arrangement may be analogous to the annual and total earnings limits under the small business tax deduction provisions under the Income Tax Act.

However, the issue of fairness can apply equally to the lower end of the income scale. We have noted on several occasions that the incentives for RRSPs, which would generally apply to RPAs as well, are typically lacking for low-income individuals. This is so because the tax-assisted features of such vehicles are worth very little to low-income earners. Moreover, the present offset features of the combination of GIS and GAINS may well imply that there is no net increment in retirement income to be gained from accumulating small amounts of pension income. There is a potentially important role for RPAs to play here. For example, for those who have had spells of very low income but have later enjoyed greater earnings potential, provisions could be made for allowing additional and/or retroactive contributions to RPAs to reflect this earlier low income. Somewhat similar provisions are now available for some groups (e.g., teachers) under the existing RRSP rules. The concern that each taxpayer have the ability to contribute some minimum amount to tax-assisted devices would appear to be the natural counterpart of the concern that other groups of taxpayers are able to make excessive contributions.

A second approach would be to subsidize the pension contributions of low-income contributors. This could be accomplished by allowing the contributors to choose between the present tax-deduction approach or an alternative approach that would allow for a refundable tax credit of, say, 35 per cent on any personal contributions to an RPA.

We raise the fair access issue not because we have a view of what is right or appropriate, but because it is critical to overall pension reform. For example, the relationship between RRSPs and RPAs effectively turns on this issue So does the question of whether the contribution limits to RRSPs and, presumably, RPAs should be indexed to the CPI. As noted in the overview section, the resolution to the general issue is intricately bound up with whether or not our taxation system is moving towards a system that taxes consumption. This is not an easy question to answer. Yet until it is resolved the notion of lower or upper bounds on access to tax-assisted pension devices is likewise likely to remain unresolved.

It should probably be noted that these considerations regarding the limits on RPAs and RRSPs generate some very important implications. Principal among these is the fact that governments have an important fiscal stake in all of this. Removing or raising ceilings on contribution limits for tax-assisted retirement savings would 'cost' the treasuries, both in terms of current tax revenues and in deferred taxes ultimately collected (assuming that the average rate of tax is lower in retirement). There might be an offset on the expenditure side - privately accumulated pension savings would reduce pensioners' claims on publicly provided retirement support.

By way of summarizing this 'fair access' issue, we note that the RPA, which is a money purchase plan and therefore essentially a 'pure pension' instrument, is nonetheless flexible enough to also serve a 'redistributional' or vertical equity role in overall pension arrangements.

Locking-in

The federal proposal for the RPA is that it be 'locked in', i.e., that the proceeds be available only for retirement income. This locking-in provision does not apply to RRSPs. They are essentially a voluntary tax-assisted savings scheme, the proceeds of which can be brought into income (and taxed) either pre- or post-retirement.

Should locking-in apply to RPAs? Indeed, should locking-in apply to any occupational plans?

In the current pension debate, the implicit, if not explicit, assumption is that locking-in is not only desirable but essential. Some of this attitude is based on paternalism: an individual must not be allowed the opportunity to squander his retirement income in pre-retirement. Perhaps part of the argument is that since the state has provided the tax-assistance for pensions it should have the right to determine when the benefits are to be derived. In any event, locking-in tends to be viewed as an integral part of the pension system.

Some Council members find this anomalous. Provided there is full taxation of any proceeds, why should an individual not be allowed to realize his pension savings at, say, 55 years of age rather than 65? Or why should an individual be prevented from using his pension accumulations to purchase equity in his own house or to purchase a small business, provided the funds are subject to taxation? Current pension regulations normally permit withdrawals up to the point at which the pension is vested. And many individuals take advantage of this opportunity. Why not after vesting as well, particularly since vesting would probably occur much earlier under pension reform than is currently the case?

We have not done sufficient research on this issue to come up with a firm recommendation one way or the other. However, we do recommend that the various governments responsible for regulating pensions to take a fresh look at the general issue of locking-in.

RPAs, pension awareness, and pension control

There is another aspect of RPAs that could have a substantial impact on the future of our enterprise system. Pension funds are increasingly becoming a major source of capital. Those who control the investment decisions of these pension pools will have a large say in the future direction of the Canadian economy. The fundamental feature of an RPA is that it would shift the control over pensions away from employers and pension pool managers and towards individuals. To be sure, responsibility for the management of RPAs of the group variety might be turned over to professional managers, at least for periods of time. Nonetheless, the basic concept embodied in an RPA is that of individual choice and management; RPAs could therefore push out asset ownership very widely and enfranchise almost everyone into the financial system.

In addition, the rules relating to disclosure and RPA performance would make contributors more aware of their current and future pension status. Under most existing occupational plans, particularly defined benefit plans, the contributors' understanding of pension mechanics is typically very limited.

Both these aspects of an RPA would contribute to a situation in which individual Canadians had a greater stake in the decisions and policies of both the private and public sectors. And, as noted above, the RPA would serve to limit the degree to which massive pools of capital, whether in the public or private sector, determine our destiny.

Mandatory RPAs?

We return once again to the question of a compulsory expansion of the pension system. As we have already noted on several occasions, a majority of the Council are against such mandatory expansion. However, we did express the view that if a compulsory expansion is in the cards, it should be fully funded and not pay-as-you-go. Moreover, we expressed concern that control over such funds be made as diverse as possible. On both these counts, a compulsory RPA system with immediate vesting provides a preferable alternative in the majority view to a mandatory CPP expansion. But to repeat, most members of the Council are not in favour of compulsory pension expansion.

Conclusion

It is tempting to become too enthusiastic about the introduction of RPAs.

Indeed, we may have focused on some of the obvious benefits that would attend their implementation to the neglect of some of the problems. The potential benefits of the RPA scheme are worth enumerating. It would enhance portability and coverage. It would facilitate earlier vesting: It should lead to an improvement in the quality of existing occupational plans. It would contribute to individuals' awareness with respect to their retirement income. It should encourage individual decision-making with respect to investment and asset ownership. To be sure, the introduction of RPAs would generate some problems for existing occupational plans. It would also pose some serious coordination problems for provincial and federal pension regulation. (These problems will be highlighted in the chapter on federal-provincial implications.) Moreover, while RPAs would enhance coverage for certain segments of the work force, they would probably not substantially increase the coverage ratios of low-income Canadians. As we have indicated, it is not clear that, under current arrangements, coverage at very low income levels is in the overall interests of workers. However, by subsidizing contribution rates for all income classes and by allowing some retroactive contribution up to specified minimum contribution entitlements, RPAs could inject a degree of 'fairness' into private pension arrangements.

On balance, the Council feels that RPAs would have a valuable role to play in the overall pension system, and we welcome the innovation.

APPENDIX 12A*
A NOTE ON THE COMPARATIVE RISK OF MONEY PURCHASE AND DEFINED BENEFIT PLANS

Economic analysis, contrary to most popular discussion, does not imply that the investment risks borne by a member of a money purchase plan are necessarily greater than those borne by a member of a defined benefit plan. The member of the money purchase plan does bear all of the investment risk. He can, however, choose the degree of risk in the context of the risk-return tradeoffs available in the capital market. If he is very risk averse (or if he becomes more risk averse as he nears retirement age), he could hold a portfolio that consisted primarily of short-term bonds or their equivalent. Historical evidence suggests that the expected real return on a portfolio of Treasury bills is about 1 per cent, and the annual real return has a standard deviation of about 2 per cent. If he were willing to forgo the higher expected real return available on riskier portfolios, the plan member could shed most of the uncertainty regarding the real return on his pension saving.

The extent to which the member of a defined benefit plan in effect bears investment risk is more difficult to determine, primarily because of the possibility of implicit risk sharing in the context of implicit labour contracts. In one sense he bears no risk. If the pension will be, say, 60 per cent of final earnings, then the worker knows that he will receive in retirement 60 per cent of the income he had become accustomed to in the final working years. This much is known with certainty, and in this sense a defined benefit plan bears no risk. But this is a very narrow definition of risk, since, as will be pointed out below, what is uncertain in this case is the worker's final earnings. More generally, the following observations are appropriate. First, a nominal deferred annuity - which is what the worker has accrued at each point in time (and what he would receive if he were terminated) - has the investment characteristics of a very long-term bond. As such, at each point in time, his accrued benefit is a very risky investment in a world of uncertain inflation and volatile inflation expectations. Second, one cannot infer from the fact that a firm holds a risky pension fund portfolio that the worker is earning a high expected real rate of return on his forgone wages. Competitive models of the labour market indicate that if a firm provides, say, a risk-free nominal pension benefit, yet holds risky assets in the pension fund, the implied return on the worker's forgone wages is only the risk-free nominal rate. Any additional expected returns flow through to the shareholders of the firm as the market-determined compensation for the firm's bearing the investment risk. In effect, there is no 'free lunch' in the capital market.

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* This discussion of investment risks in money purchase and defined benefit plans is basically an excerpt from James Pesando's overview paper on private pension reform, which is part of our background document.

The issue of the interaction of the benefit formula and the magnitude of wages increases received by the worker, which also bears on the investment risk question, may also be more subtle than is usually thought. Consider first a career average plan (i.e., a plan in which the member earns each year a pension benefit equal to a designated fraction of that year's income) which has no post-retirement indexing. Accrued benefits are thus purely nominal and have the investment characteristics of a long-term bond. If an unanticipated, transitory increase in the rate of inflation takes place, there is a once-and-for-all decline in the real value of the accrued benefit. If an unanticipated, permanent increase in the rate of inflation takes place, there is a continuing decline in the real value of the accrued benefit. The present value of this decline is equal to the change in the market price of a long-term bond in response to an unanticipated, permanent change in the rate of inflation. Since inflation and investment risk are (virtually) synonymous for fixed-income securities, the substantial investment risk borne by the member of this career average plan is readily apparent. If a member of a money purchase plan were to invest, say, in Treasury bills, he would clearly be exposed to less inflation-investment risk.

What is perhaps not so apparent, however, is that a similar result may obtain even if the plan member is in a final earnings plan (i.e., a plan in which the benefit is based on years of service and earnings during the final years of employment) with full post-retirement indexing. There are two key points here. First, until the plan member reaches retirement age, his accrued benefits are purely nominal, as in the case above.

Second, in the final earnings plan, an increase in the current wage raises the value of all previously accrued pension benefits. This does not occur in the career average plan. Indeed, this feature is cited by most commentators as evidence that the member of a final earnings plan has pension benefits which are effectively indexed during the pre-retirement period. This observation, which is based on the tendency of wages in the aggregate to rise in tandem with inflation, is potentially misleading.

The obvious point is that an increase in the nominal wage rate in the current period will raise the value of accrued benefits in a final earnings plan and thus serve - at least in part - to restore any decline in their real value that occurred as a result of inflation in the previous period. The perhaps less obvious but not less important point is that the worker may 'pay' for this restoration by accepting a lower increase in his current wage than would be the case in the career average plan. This result occurs as the enrichment of past service credits which accompanies the wage increase is factored into the competitive wage settlement. If inflation were unanticipated, its impact on the real value of accrued benefits would mirror its impact on the real value of a long-term bond, as previously discussed in the context of the career average plan.

Although there is debate among economists about the extent to which the existence of implicit contracts between workers and firms might qualify the above analysis, there is at least one fact that offers considerable support for its basic insight. That is the 'paradox' that firms in the private sector are willing to provide final earnings plans which 'index' benefits during the pre-retirement period, yet are unwilling to index benefits in the post-retirement period. This paradox is easily resolved in the context of the preceding analysis when it is recognized that only in the pre-retirement period can the firm extract current wage concessions for enrichments to the value of previously accrued benefits.

To sum up, the question of how much investment risk is borne by members of defined benefit plans is difficult to answer, given the possible existence of implicit risk-sharing contracts between workers and firms. In general, however, there can be no presumption that members of money purchase plans, who can choose the desired degree of risk in the context of risk-return tradeoffs available in the capital market, necessarily bear more risk than do members of defined benefit plans. The expanded role for money purchase plans should not be viewed as unattractive on this account. This point is reinforced by the observation that money purchase plans are fully funded, by definition, while defined benefit plans may be substantially underfunded.

RPAs:
Council Summary Observations

- Registered Pension Accounts (RPAs), essentially RRSPs into which employers can also contribute, represent an important innovation. Their introduction would serve to increase both the quality and quantity of private pensions.

- Small businesses currently unwilling or unable to implement occupational pensions would likely be attracted to RPAs. Even firms that currently provide pension plans might wish to convert their plans to the RPA format, particularly if they have a mobile labour force and are saddled with administering scores of small deferred entitlements.

- RPAs would be ideally suited to the mobile worker, since the pension would be carried and administered by the worker and not the employer.

- Regarding the characteristics of RPAs, the Council recommends the following: RPAs should be allowed to invest in a broad range of assets; multiple RPAs should be allowed in order to facilitate portfolio diversification and the spreading of institutional risk; the range of financial institutions allowed to offer and/or administer RPAs should be as broad as possible; full disclosure, including performance appraisal, should be required.

- RPAs could be used to allow each worker the right, over his working life, to shelter some minimum amount of income in tax-assisted savings. Thus, if a worker experienced lean times over his early working life, but later received higher earnings, he could be allowed to shelter income, retroactively, up to some agreed-upon minimum.

Such an arrangement would go some way toward satisfying the 'fairness' criterion that motivates much of the Green Paper.

- RPAs have the potential to increase worker pension awareness, since the money purchase nature of the plan would make contributors fully aware of their present and future pension status. Moreover, because RPA would be controlled by individuals, they would push out asset ownership widely, thereby decreasing the degree of asset control by large private pension pools.

- While locking-in appears to be one of the sacred cows in the pension debate, the Council recommends that governments take a fresh look at the issue. This is particularly important in light of the fact that implicit if not explicit in the Green Paper proposals is a rather dramatic increase in the degree to which pensions are locked in. It is probably important to ensure that the various retirement savings devices have similar locking-in provisions. At present they do not. Among the many alternatives worth considering is having all tax-assisted retirement vehicles embody compulsory locking-in at, say, age 40 and not before.

- RPAs could provide the backbone for a compulsory expansion of private pension plans. While this would be preferable to a compulsory expansion of the CPP/QPP, the Council is against such an initiative.

- RPAs are a money purchase plan, whereas most occupational plans are of the defined benefit variety. As the appendix to this chapter argues, it is not obvious that the former are more risky than the latter.

13
Pensions and Inflation Protection

Introduction

In 1980, 98.3 per cent of the pension plans in the private sector (covering 95 per cent of plan members) had no formal provisions for cost-of-living adjustments.[1] The impact of this lack of inflation protection is shown in Table 18, which presents the purchasing power erosion of flat benefit plans for selected rates of inflation and for varying time periods. With inflation proceeding at 5 per cent, the fall in the real value of a nominal pension is 54 per cent after 15 years and 81 per cent after 30 years. If the annual inflation rate is 10 per cent, the decline in purchasing power is 79 per cent and 96 respectively. Given the dramatic impact that inflation has on the real value of pensions, it is hardly surprising that inflation protection has been an issue in the pension debate. This is the case even though a considerable number of private plans do make ad hoc cost-of-living adjustments.

The Green Paper recommends that Canadians consider the following change in employer-related plans:

> ...requiring a minimum degree of inflation protection, so that pension benefits would be increased each year by at least a prescribed amount. The excess interest approach [to be detailed below] with adjustments based on the five-year average yield on long-term Government of Canada bonds minus 3.5 per cent merits careful consideration. Benefits earned to date, including those currently in pay, could be adjusted by at least the five-year average yield minus 7 per cent. (p. 56)

The purpose of this chapter is to evaluate this 'excess interest' concept as an approach to inflation protection. While the issues involved are rather straightforward, the analysis will have to become technical at times.

Before we embark on this evaluation, it will be useful to place the inflation issue in a more general context. This may appear to be a detour,

TABLE 18
Effect of inflation on fixed pension benefits

	Real reduction in pension benefits	
	After 15 yrs	After 30 yrs
Fixed nominal pensions		
5% inflation	54%	81%
7.5% inflation	69	90
10% inflation	79	96

SOURCE: John Bossons, 'Indexed bonds as an instrument of pension reform' from Ontario Economic Council background paper, proceedings from Pension Reform Conference, forthcoming.

but it will enable us to focus in the end on a broader range of issues, including such matters as benefit design and the role of indexed government bonds.

Benefit design: choice or compulsion

There are several issues relating to the design of pension benefits that once again involve us more in the realm of value judgment than of economic analysis. First, there currently exist several kinds of variable or 'escalating' annuities, which, while not fully indexed for inflation, do provide a substantial degree of inflation protection. Thus the inflation protection issue is more of a concern for defined benefit plans than it is for money purchase plans, since the latter can be used to purchase variable annuities. Yet, as our background research points out, persons with maturing RRSPs almost universally opt for nominal, equal-payment annuities. In other words, individuals clearly prefer high-start, equal-payment annuities to low-start, escalating nominal annuities. This can be rational behaviour. For example, pensioners may be able to hedge against inflation in the context of their total retirement portfolios, and presumably can do so at a lesser cost than by resorting to variable annuities as currently priced.

Second, the fact that many or most benefits under occupational plans are not protected from inflation is probably one of the reasons for the existence of poverty among the elderly. In particular, because of the normal age differential between husband and wife and the longer life expectancy of women, it is probably the non-indexation of private pension benefits (and the inadequacy of survivor benefits) that has led to the high incidence of poverty among elderly women.

Third, income-tested programs such as GIS and GAINS likely provide a bias *against* acquiring inflation-protected pension benefits. Opting for equal nominal payments (which imply higher real benefits now and much lower real benefits later) may increase a pensioner's overall level of expected consumption during retirement. This is so because *indexed public pensions can be substituted for the falling real value of private pensions in later years of life*.

Fourth, it is probably optimal to plan for *some* decline over time in the real value of pension income; i.e., *full* indexation is probably not optimal. This is so because the ability to consume probably declines with increasing age.

Fifth, inflation protection is not free. The markets for escalating annuities or real valued annuities are not fully developed, so a pensioner desiring such an annuity may have to pay a considerable premium.

What do all these factors, and presumably others as well, imply about whether society should 'require' that pensions be protected from inflation? This issue is extremely complex. At one end of the spectrum the issue may in the final analysis be decided by the courts: the concept of marriage as an equal partnership may eventually be construed as requiring a retiring couple to purchase a joint and last survivor annuity denominated in real terms. Closer to the realm of economic analysis, an argument for requiring some inflation protection might be made in terms of the third point above - for those who have sufficient retirement income initially (and are presumably well-off), failure to inflation-protect their pensions means that they will eventually transfer the costs of their support to the rest of society via GIS. Another approach might be to argue that since the government has provided the tax-assisted pension vehicle in the first place, it should have the right to decide how any accumulated assets should be invested when they are withdrawn. However, neither of these latter two arguments is especially convincing.

On balance, the Council has come down in favour of requiring some degree of inflation protection. The basis for this position is only partly related to the above considerations. It also has to do with the following. Consider an annuity that is calculated on the basis of an expected rate of interest, say 5 per cent. Suppose that the rate of inflation rises unexpectedly and interest rates rise apace, say to 10 per cent. Since it takes only 5 per cent to finance the annuity, some 'excess earnings' will accrue to the fund. These excess earnings can be retained by the shareholders, they can be used to reduce contributions for existing workers, or they can be used to increase benefits. We believe that an argument can be made that some of these earnings ought to go to enhancing benefits for the retired.

This, of course, is quite close to the 'excess interest' approach that the Green Paper proposes. However, in many respects the specifics of the Green Paper proposal are deficient, as the following sections will make clear.

The basics of 'excess interest'

In order to provide a background for the Green Paper proposals, it is useful to trace through a series of alternative annuity arrangements. These are adapted from an Ontario Economic Council discussion paper authored by James Pesando.[2]

Suppose on retirement a worker is entitled, under a defined benefit plan, to a pension of $10,000 per year. Let us assume that the worker will live, actuarially, for ten years and will receive a single pension payment (annuity payment) at the end of each year. The amount of funds that the firm will have to set aside to generate this benefit will depend on what is known as a valuation rate of the annuity. At a valuation rate of 4 per cent, the firm would have to set aside $81,108. For higher valuation rates, a smaller capital sum would be required and vice versa. In order to facilitate comparison with the Green Paper proposal, we shall assume that this valuation rate is 3.5 per cent.

Case 1: No inflation protection

The worker receives $10,000 per year, regardless of the performance of the pension fund. If the inflation rate in the first period is 6 per cent, the real value of the pension drops by roughly 6 per cent, etc. If the pension fund earns more than the valuation rate of 3½ per cent, the surplus goes to firm profits or perhaps to increase the pensions of active workers. This is the no-inflation-protection model.

Case 2: An escalating annuity with a base pension of $10,000

Suppose that the earnings in the pension fund in the first period are 8½ per cent. Given a valuation rate of 3½ per cent, the fund has excess earnings of 5 per cent. As a result, the amount of the pension at the end of period one is increased by 5 per cent, i.e., to $10,500. In this case, the real value of the pension declines by roughly 1 per cent, since the rate of inflation is 6 per cent. However, if the fund earns only 2 per cent, the amount of the nominal pension will decline by 1½ per cent and the real decline will be roughly 7½ per cent. In other words, the value of the annual pension is a function of the performance of the fund relative to the valuation rate.

In principle, the variable annuity model is identical to the 'pure' version of an excess interest approach. However, the Green Paper approach to excess interest has a few extra wrinkles.

Case 3: The Green Paper excess interest approach

The Green Paper departs from the traditional variable annuity model in two ways:

1. it defines a guide rate which substitutes for the actual performance of the pension fund in the calculation of excess interest. In effect, this guide rate is likely to be the return on a 'benchmark' portfolio, not the actual portfolio that the fund holds.
2. it defines a base rate which is to be subtracted from the guide rate to generate the amount of excess interest. In the Green Paper, the proposed base rate is 3½ per cent, which is identical to the valuation rate that we assumed for this example. But it need not be.

With this modification, the Green Paper's excess interest approach is no longer all that similar to the traditional variable annuity. Assuming that the base rate and valuation rate are identical, the actual earnings of the pension fund's portfolio are no longer relevant to the determination of the amount of excess interest (or percentage pension increase). This will be determined by the guide rate relative to the base rate. If the guide rate is 9½ per cent and the base rate is 3½ per cent, the annual pension will increase by 6 per cent in the following year. Thus, if the actual return on the pension portfolio is 11½ per cent, a 2 per cent net 'gain', as it were, will accrue to the firm. This feature is important in the sense that there will still be an incentive for the pension fund to perform well. If, however, the fund earns only 7½ per cent, the fund must bear the 2 per cent shortfall since the pension increase will still be 6 per cent for the following year.

Setting the guide rate

It is clear that the criteria for setting the guide rate become critical. Assuming that the goal is to offset inflation, there are two attributes that a guide rate should have:

1. it should exhibit a pattern similar to that of the inflation rate.

2. if the guide rate is defined by a benchmark portfolio of assets, then the fund should be able to minimize risk by holding this benchmark portfolio.

The Green Paper's proposal for the guide is the *yield* on a benchmark portfolio of long-term Government of Canada bonds. As our background research points out very clearly, *this is a highly inappropriate choice for the guide rate*. In particular, it does not satisfy the second criterion above. As inflation rises, interest rates will also rise. Hence the yield on long-term bonds will move up and down with inflation. But the *return* on a portfolio of long-term bonds, as distinct from the yield or interest rate, is likely to move in the *opposite* direction. This follows from the inverse relationship between interest rates and bond prices: as interest rates rise, bond prices fall and vice versa. Hence, in a period when the yield (interest rate) on long-term bonds rises the return on the bond portfolio will fall because falling bond prices generate capital losses. In turn, this means that a pension fund holding the Green Paper's benchmark portfolio for the guide rate *cannot* minimize its risk. Indeed, the opposite is the case - as the inflation rate, the yield on the benchmark portfolio, and therefore next year's nominal pension rise, a pension fund holding the benchmark portfolio will experience a fall in its rate of return and perhaps even a negative return.

The Council is unanimous in rejecting the Green Paper's proposal that the yield on a portfolio of long-term Canada bonds serve as the guide rate for an excess interest scheme.

An alternative benchmark portfolio

The paper by James Pesando in our background document suggests an alternative for the guide rate, namely a benchmark portfolio of treasury bills and short-term bonds (less than one year to maturity). This alternative is superior to the Green Paper proposal in terms of both the above criteria. First, short-term yields tend to move with the inflation rate more than do long-term yields. Second, since capital losses or gains tend to be minimal for very short-term securities, a pension fund would be able to minimize risk by holding this benchmark portfolio.

Some elaboration of this latter point is appropriate. The evidence available suggests that the real return on a portfolio of treasury bills is about 1 per cent; i.e., the interest rates on treasury bills tend, on average, to be about 1 per cent above the inflation rate. What does this imply about the behaviour of pensions under a scenario in which the guide rate is a portfolio of treasury bills? If the inflation rate is 6½ per cent, then the yield on a portfolio of treasury bills will be roughly 7½ per cent. With 7½ per cent as the guide rate and 3½ per cent as the base rate, the nominal value of a pension will increase by 4 per cent. This means that the real value of pensions will decrease by 2½ per cent per year.

As noted above, a slight decline in the real purchasing power of pensions may be optimal, since the desire of the elderly to consume probably declines with increasing age.

There are, however, several problems with using the yield on a portfolio of treasury bills as the determinant of the guide rate. First, while a pension fund can, by holding such a portfolio, minimize risk under an excess interest scheme, a portfolio of very short-term securities will on average generate a relatively low real rate of return. Second, the investment of all pension funds in the benchmark portfolio would have dramatic implications for the capital market. The Green Paper suggests, quite appropriately, that pensioners who have access to indexed pensions (primarily public sector pensions) be exempt from the excess interest proposals. The Council recommends that some further exemptions be allowed. Specifically, pensioners should be able to opt for any standard variable annuity as long as the valuation rate is equal to the base rate in the excess interest proposal. The annual pension payments would be more risky in this case than they would be if the variable annuity were tied to a portfolio of treasury bills, but the average rate of return would probably be greater.

More generally, the Council feels that a mandatory scheme incorporating an excess interest scheme is a mixed blessing. This is an area where much more research is needed. As a minimum, the Council recommends that upon retirement individuals be allowed the flexibility of opting for a variable rate or escalating annuity.

Indexed government bonds

One obvious way to provide inflation protection is for a pension fund to invest in indexed bonds. The characteristic of an indexed bond is that the interest rate is set in real (after-inflation) terms. Thus, a 2 per cent real-term bond would pay 12 per cent interest if the inflation rate were 10 per cent and would yield 6 per cent if the inflation rate were 4 per cent. The difficulty with this alternative is that such indexed bonds do not exist.

In our 1982 position paper, Inflation and the Taxation of Personal Investment Income, the Ontario Economic Council came out in favour of the proposition that the federal government (and anyone else for that matter) issue indexed bonds. Experience from Britain suggests that such bonds would be priced at a real interest rate in the neighbourhood of 2-3 per cent. As an approach to the inflation protection issue, indexed bonds may be an ideal compromise. First, they would guarantee that nominal pension levels moved in unison with the inflation rate. Second, the return on a portfolio of indexed bonds would typically exceed the return on a portfolio of treasury bills. In short, under such a scheme not only would pensions be adequately indexed for inflation but the rate of return would be higher. Hence, the Council recommends that the federal government investigate the possibility of issuing indexed bonds, possibly restricting the initial issues to pension funds. However, our earlier concern is still relevant, namely that individuals be free to purchase variable annuities in lieu of 'excess interest' annuities, even if the 'excess interest' scheme allows for the purchase of indexed bonds.

Active vs. inactive workers

The above analysis was designed to apply to retired workers. However, the Green Paper proposals with respect to excess interest are intended to cover active workers and are also intended to apply, with less force, to past pension credits. Both of these recommendations are questionable.

We have on several occasions made the point that retroactive overrides of private sector contracts are inappropriate. Therefore, we take a dim view of the suggestion that the inflation protection scheme apply to past credits. Indeed, it would probably be appropriate for the application of the excess interest program to give the near-retirees some lead time in which to adjust to the fact that their pension benefits in the initial years will be lower than anticipated.

The second concern relates to active workers. Should the excess interest approach be applied to their accrued and accruing benefits? This is not an easy issue to deal with. The majority Council opinion is that the inflation protection scheme should not be required for active workers. Pension benefits are, or ought to be, an integral component of collective bargaining arrangements. As long as there is full disclosure to employees and employers of the current position of the pension fund performance, we believe that the inflation protection to be accorded to the benefits of still-active workers can be most effectively dealt with within the collective bargaining framework. Therefore, we take issue with the Green Paper proposal that the excess interest approach be mandatory with respect to active workers.

Public sector plans and indexation

All Canadians would like to be able to prevent their retirement income from eroding in real terms. However, only a select few of us have pensions that are denominated in real terms. Most of these pension plans are public sector plans. The oft-heard suggestion is that private plans ought to follow the public sector lead in terms of inflation protection or, alternatively, the public sector presence in the pension field should be enhanced. Appealing as this may appear, the fact is that a substantial portion of the indexing provision in public plans is, or will be, paid for by the general taxpayer, present but mostly future. This point was emphasized in Chapter 4, where estimates were produced indicating that full funding of the federal government pension plan would require an additional annual contribution equal to 11 per cent of the federal payroll. This may not hold for all indexed plans. However, consistent with the general approach we have adopted in this document, the Council recommends:

1. That there be public disclosure of the full cost of the pension benefits of public sector plans. This should include a costing out, on a scenario basis, of a comparison with the benefits payable under various private sector plans.

2. That pension arrangements be part of the collective bargaining process. At present this is not the case with respect to some public sector plans.

Inflation Protection: Council Summary Observations

- Inflation can erode dramatically the real value of pensions.

- However, the lack of inflation protection in most pension plans need not imply that recipients have no inflation protection. Pensioners may be able to hedge against inflation in the context of their overall retirement portfolios and at a lesser cost given the present poorly developed markets for real-term annuities. Compared with an equal-nominal payment annuity, an indexed annuity would have lower initial nominal payments and, depending on the inflation rate, higher later nominal payments. This being the case, a pensioner could do his own indexing by investing the initial payment excess in securities that tend to keep pace with inflation (e.g., CSBs).

- The non-indexation of pensions, combined with inadequate survivor benefits, has probably contributed to the high incidence of poverty among elderly women.

- The fact that income support levels of the public pension system are indexed for inflation provides an incentive for individuals to draw equal-nominal-term pensions. Higher initial consumption is supplemented in later life by the indexed public system as the real value of the pension payments falls. Under an inflation-proof system, some of these pensioners might never be eligible for GIS, for example.

- An argument can be made that pensioners under equal-nominal-payment plans have a right to any excess nominal earnings arising from unexpectedly high rates of interest and inflation. This is a variant of the excess interest approach to inflation protection.

- Money purchase plans provide more flexibility than defined benefit plans in terms of enabling pensioners to cope with inflation.

- The Green Paper's specific proposal for excess interest is woefully inadequate. The variant proposed in the present chapter is much preferable.

- Excess interest annuities should not be compulsory. At the very least, pensioners should have the right to opt for variable or escalating annuities.

- Under present institutional arrangements, compulsory indexation of all annuities would be very expensive. If this were ever contemplated, and we do not recommend that it should be, considerable lead time would have to be allowed for the development of a full-fledged market in real-term instruments. Indexed government bonds could play an important role in developing such markets.

- Inflation-protection measures should not be retroactive.

- The excess interest approach, desirable as it may be for retired persons, should not be applied to active workers. With full disclosure, any excess earnings of the pension fund can be dealt with in the collective bargaining context.

- Public sector pension plans should be required to provide full costing of their benefits, including provisions for automatic indexing. In addition, pension arrangements should be part of the collective bargaining process.

14
Ensuring Fairness in Employer Plans: Portability, Vesting, Locking-in, Spousal Concerns

Introduction

The purpose of this chapter is to present the Council's views on a series of issues that relate to employer pension plans. The following chapter will focus on a similar set of concerns that relate to public sector plans.

The general rubric under which the Green Paper classifies these issues is that of 'ensuring fairness' in the accumulation of pension assets. At the outset, it must be noted that 'fairness' is a rather slippery concept. For example, suppose that one of two groups of workers has a 'richer' pension plan but the other group has an appropriately larger current wage. There is nothing that is unfair about this arrangement. Situations like these could easily arise within the collective bargaining context. In general, therefore, the notion that some groups of workers are being treated unfairly because other groups have better pensions simply does not wash unless it is also the case that there are no compensating wage differentials. With this important caveat, we now turn to some of the issues that the Green Paper groups under its fairness objective.

Portability

Increasing the portability of existing pension plans is at the top of the Council's reform agenda for occupational plans. Indeed, much greater portability must be a characteristic of the private pension system. Most of the discussion and analysis in the chapter on RPAs was motivated by a concern for enhanced portability as are many of the recommendations in the present chapter. The special responsibility that falls to the provinces, and particularly Ontario, with respect to portability and with respect to ensuring a Canada-wide labour market will be dealt with in more detail in the penultimate chapter of this document.

Vesting

Most pension reports recommend earlier vesting. The current legislation for most plans requires vesting for those aged 45 or over who terminate employment after ten years of service. In Saskatchewan vesting is mandatory for all plan members whose age plus years of service total 45, provided there is at least one year of service prior to termination. Manitoba requirs vesting after ten years of service regardless of age, and its recent pension commission report recommends that this be reduced to two years. It should be noted that some employer plans provide vesting sooner than the legislation in their jurisdiction requires.

The Council agrees that there is a need for earlier vesting. The Green Paper proposal is for vesting after two years. In our opinion, two-year vesting without any age requirement is likely to work to the detriment of young workers. Earlier in this document, we noted that earlier vesting is likely to result in a combination of offsetting wage differentials and a tendency for firms to shy away from on-the-job training. For younger, less-skilled workers, compulsory vesting may have a very negative impact on lifetime potential earnings if firms respond to early vesting by cutting back on on-the-job training. Hence, we offer for consideration the proposal that prior to age 30, vesting take place after five years of service. For persons aged 30 and above, compulsory vesting after two years seems appropriate.

Locking-in

In our discussion of RPAs, we advanced the view, held by some Council members, that mandatory locking-in of pensions is a questionable feature of a pension system. Lifestyles are becoming more flexible, and perhaps the time has come to think about introducing more flexibility into the system of tax-assisted savings.

It would appear that there is an implicit assumption in the Green Paper that locking-in would go along with vesting. This would mean a dramatic increase in the degree to which pensions were locked in. And this in turn could pose a serious problem: some tax-assisted retirement vehicles might be locked in while others (e.g., RRSPs) were not. There is no easy solution to this general issue. It is true that if pensions were not locked in some people might 'squander' their retirement income. On the other hand, others would likely utilize their accrued pensions to acquire equity in their homes or to acquire other assets that would serve them well in retirement.

Locking-in need not be a zero-one game in the sense that the choice does not have to be between no locking-in at the one extreme and locking-in in combination with vesting at the other. Proposals for locking-in at, say, age 40 for all tax-assisted savings represent an intermediate approach.

The Council is divided in this issue. Some Council members would prefer a system that did not involve any locking-in whatsoever. Others would prefer a system where locking-in took affect at, say, age 40. In general, however, we are very concerned about the implicit assumption of the Green Paper proposals that pensions would be locked in as soon as they were vested.

Disclosure

The Council agrees with the Green Paper that substantially more information relating to pensions should be made available to plan members and their spouses. Plan administrators should be required to make available each year information about the employer's accrued benefits, the present value of benefits earned to date, the financial status of the plan, and, in particular, the extent to which the fund covers pension liabilities. It is equally imperative that when employees reach retirement age they be provided with full information about such things as variable annuities and joint and last survivor pensions. There is an obvious role for government here.

Plan termination insurance

Ontario is the only province to have instituted plan termination insurance, which guarantees the payment of workers' pensions in the event of bankruptcy or plant closure. The Green Paper proposes a plan termination scheme with a guarantee corporation operated under joint federal and provincial auspices. Our background research suggests that there are likely to be problems associated with any such insurance scheme for pension plans. It indicates that a combination of greater information disclosure and tighter funding requirements might obviate the need for such insurance. We might add that RPAs could provide a viable alternative for pension plans that are poorly funded.

Since the Council views pensions as 'deferred wages', we take the position that workers' pensions must be guaranteed. However, it seems to us that in Ontario sufficient guarantees are already in place apart from the existing plan termination insurance. Ontario's Pension Benefit Guarantee Fund, which exacts contributions from private plans that are not fully funded (and in proportion to the underfunding), appears to be an adequate safeguard. The operation of this fund could be improved by ensuring that contributions were made on a more timely basis, since this would provide the fund with an early warning device, as it were, to alert it to plans that might be in trouble.

In our view, therefore, plan termination insurance is probably not warranted in the Ontario context. Before the various pension authorities recommend that some version of plan termination insurance be made compulsory, they should a) take a closer look at Ontario's overall safeguards, including its Pension Benefit Guarantee Fund, and b) evaluate this alternative to plan termination insurance as a method of guaranteeing workers' pensions both in Ontario and elsewhere. Indeed, some other provinces may well have even more effective legislation in place than has Ontario. In any event, we support the principle that pension entitlements ought to be secure: we question only the means by which this objective is to be achieved.

Survivor benefits

In 1980, 45 per cent of occupational plan members belonged to a plan that provided a regular pension for the surviving spouse in the event of death before retirement. These survivor pensions generally amounted to 50 per cent of the pension that the deceased plan member was entitled to at time of death. Other plans provided survivor benefits in the form of a single lump sum repayment of past employee contributions and vested employer contributions. Fully 71 per cent of public sector plan members were eligible for regular survivor pensions, compared with 24 per cent of private plan members. Private sector plans typically provided survivor benefits in the form of a single lump sum payment at the time of death.

However, 30 per cent of private sector plan members belonged to plans that provided no death benefits, compared with a miniscule percentage of public sector plan members.

Again in 1980, 43 per cent of all plan members in 1980 belonged to a plan that provided regular pensions for surviving spouses in the event of death after retirement. Seventy per cent of public sector plan members belonged to such plans, compared with 22 per cent of private plan members. 48 per cent of private sector plan members belonged to plans that paid benefits for a specified period after retirement (usually five years), with full benefits being paid to the surviving spouse from the time of death to the end of the guaranteed period. Only 9 per cent of public sector plan members belonged to plans that provided survivor benefits on this basis. Thirteen per cent of all occupational plan members belonged to plans that contained no provision for survivor benefits.

Thus there is a wide variation in the manner in which the current arrangements deal with survivor benefits.

In regard to the provisions for a surviving spouse of an employee who dies prior to retirement, the Council accepts the Green Paper's recommendation that

> ...the surviving spouse...be given at least the full value of the contributor's accrued pension. With [these] accumulated pension credits, the survivor would have the same choices as an employee who changes employers [see the relevant section in the Chapter on RPAs]. However, if the pension plan already has survivor benefits, the survivor could choose to take the survivor benefit instead. (p. 30)

In regard to spousal benefits for death after retirement, virtually all pension reform documents suggest that survivor benefits be mandatory unless explicitly waived in writing by both employee and spouse. The Council supports this recommendation.

There is some disagreement among the various recent pension documents as to whether the survivor benefit should be 60 per cent or two-thirds of the retired employee's benefit. We do not believe that the exact percentage is all that crucial. Suppose, for example, that 60 per cent was agreed upon. Presumably one of the alternatives, if both parties agreed, would be to purchase a joint and last survivor policy that had a 66 2/3 per cent survivor benefit; or the couple might want higher initial pension payments and, therefore, might opt for a 50 per cent survivor benefit.

The Council feels that this recommendation ought to be introduced with some lead time. Improved survivor benefits will be obtained only by decreasing the initial level of the pension or, in the longer run, by greater contributions. In order to facilitate the transition to mandatory joint and last survivor pension (unless waived), it seems appropriate to allow those near retirement to adjust to this new provision. For example, they could be allowed to make greater use of RRSPs or RPAs in order to provide a smoother transition from work to retirement.

This general recommendation, along with greater disclosure, should give couples a much-enhanced awareness of their pension status. The waiver feature is important in order to provide couples, fully aware of their respective pension rights, with maximum flexibility in planning their retirement years.

Finally, since survivor benefits are 'earned', they should not be affected by remarriage.

Credit-splitting

A more controversial issue relates to mandatory splitting of pension rights on marriage breakdown. The CAPSA (Canadian Association of Pension Supervisory Authorities) proposal with regard to this issue is the following:

> The division of rights to property on marriage breakdown is a matter for the courts or negotiation between the parties. Pension regulatory legislation should not attempt any prescription. However, the legislation should permit division of benefits in response to a court order but should contain limits to avoid the creation of new obligations for the pension plan.[1]

While the Council agrees in principle with the proposition that certain issues in the pension area are best left to the courts, there have been some recent developments with respect to credit-splitting and marital breakdown that warrant elaboration. Manitoba's new pension regulatory legislation (to take effect 1 January 1984) contains the following provision: pension benefits earned during the course of a marriage or a common-law relationship will be shared evenly in the event of a marriage breakdown. A similar proposal is incorporated in the brief to the Parliamentary Task Force on Pension Reform prepared by the Ontario Status of Women Council.[2] Presumably this recommendation is directed as much to the province of Ontario as to Ottawa, since the former has the power to regulate private pensions within the boundaries of the province. While

British Columbia has not enacted its own pension regulatory legislation, a broadly similar provision has recently been incorporated in its legislation with respect to family law reform. In all likelihood, this sort of provision will find its way into more provincial legislation.

The division of pension assets on marriage breakdown is extremely complex, even if the prevailing law suggests that the assets should be divided evenly between the spouses. Will the courts require that any and all pension-asset division be in terms of a retirement (i.e. locked-in) benefit, or will they allow these future benefits to be taken into current income? How will the courts assess the present value of a final-earnings defined-benefit plan? And so on. Presumably the courts of the various provinces will attempt to sort these issues out in their respective ways. After a reasonable time period, however, it is probably appropriate that some degree of uniformity be imposed upon the system. In turn, this will likely require that pension regulatory legislation, in addition to family law reform, will have to address these issues, particularly with respect to the manner in which one might value pension entitlements in mid-stream, as it were.

Unisex tables[3]

The U.S. Supreme Court has recently handed down a ruling that prohibits employers from offering pension plans that provide men and women with unequal benefits:

> Even a true generalization about a class cannot justify class-based treatment. An individual woman may not be paid lower monthly benefits simply because women as a class live longer than men.[4]

The legislation underpinning this ruling was the 1964 Civil Rights Act, which makes it unlawful for any employer to discriminate because of race, colour, religion, sex, or national origin. The 1977 Canadian Human Rights Act contains roughly the same provisions. However, it provides general exceptions for age, sex, and marital status in benefit plans where differentiation is on an actuarial basis.

In the spring of 1985 the equality provisions of the new Charter of Rights and Freedoms will take effect. They prohibit discrimination based on sex. Whether this will be interpreted by the Canadian Supreme Court as requiring unisex benefit tables is beyond our ability to assess.

This issue of unisex annuity tables has become an important one in pension reform. Manitoba recently amended its pension law to prohibit unequal pension benefits for men and women who make the same contributions to employer-sponsored retirement plans. The Ontario Royal Commission on Pensions recommended equality of benefits, as did the pension brief prepared for the Parliamentary Task Force by the Ontario Status of Women Council.

Unisex tables are an issue that relates, principally, to money purchase plans. Under defined-benefit plans, where the pension entitlement is, say, 60 per cent of final average earnings, benefits are in fact unisex in nature: the 60 per cent of final average earnings is paid regardless of sex. The longer life expectancy of women (and, hence, the greater cost of a given annual pension payment) may be taken into account by employers in terms of the promotion policies for their employees, although there is no empirical research that we are aware of on this issue.

Since RPAs are, in effect, a money purchase plan, the issue of unisex tables will become more important if RPAs become a significant feature of the private pension system.

Under current arrangements, annuities are classified by sex. For a given pension fund, males can purchase an annuity that delivers higher annual payments than females can because, on average, females live longer. This difference in annual payments is substantial, since at the age of 60 the life expectancy of women is roughly one-third longer than that of men.

Mandatory unisex tables would result in higher pension benefits for women and lower pension benefits for men. If the unisex concept were extended across the remainder of the insurance field, women would pay less than they do now for health insurance and more for life insurance and for car insurance. The opposite would of course hold for men.

The problem with legislating a move away from the insurance principle is that what economists refer to as 'adverse selection' would come into play - there would be a tendency for men not to buy annuities and for women not to buy life insurance and car insurance. To focus on just the pension area, unless men were forced to buy annuities with their pension pools they would seek out other avenues, and the unisex annuity tables would eventually collapse into female life expectancy tables.

This issue can be illustrated in more general terms as follows. Suppose that a group of individuals (some male and some female, some in good health and others in poor health) retires at age 65 and that each has an accumulated pension fund of $100,000. Suppose that each buys $100,000 worth of debt instruments (e.g., CSBs, short-term government bonds, interest-bearing bank deposits). The amount that each draws into annual income will presumably relate to his or her life expectancy. Factors such as, say, health and family medical history will presumably play a role in determining the annual withdrawal from capital. Those who expect to live longer will draw smaller annual payments and vice versa. Suppose, further, that we modify the example to assume that all the retirees are in average health and that each assesses his or her life expectancy in terms of the tables for men and women. As a result, the women will draw smaller annual pension payments than the men. Even though there is no compulsion involved here, this runs counter to the notion of unisex tables. What satisfaction of the unisex criterion would require is that market instruments purchased by women bear a higher rate of return than similar instruments purchased by men. This is, in essence, what is troublesome about unisex annuity tables.

The Council does not wish to prejudge how the Canadian courts are likely to rule on this issue of unisex annuity tables. However, throughout our document we have stressed the necessity that retirement income arrangements be as flexible as possible. Thus, irrespective of how the courts evaluate this issue, it is important that retirees have the option to create their own annuities by going to the market themselves. If unisex tables become mandatory, men will likely be lured into managing their own pensions. If unisex tables are outlawed, women will likely be encouraged to manage their own retirement incomes. In either case, flexibility is desirable. Note that the Council would make this same argument for flexibility even if the life expectancies of males and females were identical.

Women and pensions

We have so far steered away from viewing pensions in terms of a 'women's problem', although we have noted that a majority of the elderly poor are single women. Now that we have broached the issue in terms of unisex tables, it seems appropriate to provide some elaboration.

The role of women in pension reform is dealt with in considerable detail in our background document, notably in the papers by Monica Townson, Marie Corbett, and Terry Bissett. Monica Townson cautions all of us not to base pension reform for women on old-fashioned notions relating to women and the workplace:

> The traditional family where the man is the breadwinner and the wife stays home has already passed into history...Most women in the workforce are likely to be members of two-earner couples or single individuals [so that it is misleading to assess the appropriateness of such things as replacement rates on the basis of one-earner couples]...
>
> It is worth making the point here that the majority of Canadian women now participate in the workforce; that participation rates for women in the prime childbearing years, that is between 25 and 34, have now reached 72 per cent in Ontario; for Canada as a whole 45 per cent of mothers with children under the age of 3 now participate in the workforce (that, incidentally, represents a 40 per cent increase in the participation rate of that group in the six-year period from 1976 to 1981). And finally, I must emphasize that, contrary to public perception or misperception, the lowest percentage of part-time employment among women is for the age group 25-44 - again, the main childbearing years. More than 79 per cent of employed women in that age group had full-time jobs (in 1981). I think it is important to keep these facts in mind when we are discussing pension reform for women. They highlight the dangers of basing pension reform for women on outdated roles and stereotypes.[5]

This train of analysis, among other factors, leads Townson to reject the notion of homemakers' pensions. It also leads her to argue that greater coverage for women is critical.

Marie Corbett, Q.C., points out in her background paper that the work patterns of women are such that defined benefit plans (to which the majority of covered women belong) are not as flexible as money purchase plans:

> The defined benefit design has several detrimental effects for women. In career average earnings and final pay plans, deterioration of benefits through inflation is rapid compared to defined contribution on money purchase plans. Also final pay plans have a highly restrictive effect on mobility.[6]

In combination, these concerns, and those raised by many others in the pension debate, suggest that consideration be given to an RPA-led compulsory expansion of private sector plans. As we have stated on previous occasions, if compulsory pension expansion is in the cards it is preferable that it be undertaken in the private sector, and the characteristics of RPAs do make them very appealing to mobile workers and persons with variable work patterns. Again, however, we have serious reservations about mandatory expansion.

The various reform measures would improve the quality of pension plans for all workers, including women. Indeed, earlier vesting, enhanced portability, and inflation protection would ensure that women already covered have access to better pension entitlements. RPAs would also make a substantial contribution to improving existing plans: employers would come under substantial pressure to ensure that their existing plans were competitive with RPAs. The Council believes that the availability of RPAs would also lead to a substantial extension of coverage. Not only would financial institutions be active in marketing RPAs to companies with no existing plans, but the latter would be able to mount pension plans at much lower costs than is presently the case. With the heightened awareness of pensions that full disclosure would encourage, workers in non-pension-plan employment would generate pressure on employers to initiate plans.

To be sure, the Council recognizes that private sector reform along these lines would not lead to the coverage that would occur under a mandatory scheme. However, mandatory coverage would not be costless to workers. Indeed, it is probable that in general pension reform costs would be borne by the workers in the form of either reduced take-home pay or reduced employment or both. The recent research emanating from Laval (see Chapter 3) that suggests that a 1 percentage point increase in payroll taxes would result in the loss of 20,000 jobs, mostly among the young age group and among women, is surely cause for some concern. We have already argued that CPP coverage of low income groups is very questionable, in the sense that it is most likely to result in a decrease in their lifetime income. This is particularly the case given the present features of the system of income support for the elderly. A much better arrangement, in our view, would be one that provided for retroactive and subsidized (via a refundable tax credit) contributions to tax-assisted savings vehicles such as RPAs and RRSPs in later life if workers' incomes improved. More generally, our position is that to a considerable degree the coverage problem is a low-income problem (see Table 17). After all, it is present income that is used to purchase future (retirement) income. Meaningful pension entitlements simply cannot be accumulated at low-income levels. It is the Council's view that one of the keys to this whole problem is to ensure that women (and others as well) are provided with equal opportunities in the markets for labour. As women's incomes rise, their access to the pension systems and their ability to accumulate meaningful entitlements will increase apace.

This is the rationale for our decision not to endorse a mandatory RPA-led expansion of the private pension system. We recognize that others will have different views.

Public sector plans

Finally, there is yet another contentious issue in the pension debate: should pension arrangements for public sector employees be subject to the same regulations as those that apply to private-sector plans (e.g., full funding, using excess interest as a means of inflation protection). In roughly half of the major pension reform reports this issue is not addressed. Included in this category are the Green Paper, the CAPSA report, the CLC report, and the report of the Pension Commission of Manitoba. In the other major documents (the ECC report, the report of the Business Committee on Pension Policy, the Haley Report, the report of the Ontario Select Committee, and the British Columbia discussion paper), there is a call for making public sector pension arrangements subject to the same regulations as private sector pensions.

In the previous chapter, the Council suggested that there be greater disclosure (to Canadians and to contributors) of the value of pension benefits in public sector plans. This would include a costing-out of items such as inflation protection on a comparative basis with various existing private-sector plans. We have also made the point that, whenever possible, the determination of pension arrangements should be part of the collective bargaining process. These measures would go part way toward meeting the suggestions of those groups that are concerned with the current public sector arrangements. On the other hand, they would allow the public sector plans to continue with their existing arrangements where this was deemed appropriate.

Ensuring Fairness In Employer Plans: Council Summary Observations

- Some groups of workers will have better pensions than other, similarly-situated groups of workers. This is no cause for concern if there exist compensating wage differentials.

- Portability of private pensions must be enhanced. As noted in Chapter 12, RPAs would facilitate portability.

- Vesting should occur earlier. Our suggestion is that vesting for workers under 30 take place after five years of service, with vesting after two years for those over 30. The purpose of this measure would be to encourage firms to invest in on-the-job training for their younger employees.

- As we noted in connection with RPAs, the Council suggests that the authorities re-examine the locking-in principle, particularly since the overall thrust of pension reform will increase substantially the degree to which pensions are locked in.

- Full disclosure of an employee's annual pension status is essential. So is full disclosure of various annuity options once an employee nears retirement.

- Steps should be taken to ensure that employees' pensions are secure. Again, RPAs have a role to play here. Plan termination insurance represents one possible option. In the Ontario context, however, it appears that there is adequate protection without plan termination insurance.

- If death occurs prior to retirement, the surviving spouse should have access to the full value of the contributor's accrued pension.

- When death occurs after retirement, survivor benefits should be mandatory unless they have been waived in writing by employee and spouse.

- Legislation in the various provinces appears to be moving in the direction of mandatory and equal credit splitting of pension rights on marriage breakdown. If this is indeed the case, then it will be necessary for the various provinces to attempt to ensure that their various provisions are reasonably uniform. Provincial pension regulatory legislation may have to incorporate measures to aid the courts in this complex area.

- Classification by sex is currently utilized in most benefit areas - life insurance, car insurance, health insurance, pension benefits. Removing sex as a classification for determining actuarially based benefits will pose substantial problems for the insurance industry. Consistent with our general approach to the provision of retirement income arrangements, it is essential that flexibility be ensured. If the courts mandate unisex annuity tables, it is important that retirees (in this case mostly men) be able to seek out alternative annuity arrangements, such as managing their own retirement pensions. If legislation or the courts do not require unisex tables, it is still desirable that retirees (in this case mostly women) have the option of managing their own pension portfolios.

- The Council recognizes that the extension of coverage is one of the major goals of pension reform. One alternative is mandatory RPA-led expansion of the private pension system. This would lead to greater coverage than the Council's own proposals for reform. However, it would also lead to some substantial costs for certain groups, such as low-income and mobile workers. On balance, we feel that our package of reform proposals is more appropriate at this time than a compulsory pension expansion.

- If a compulsory expansion is in the cards, however, an RPA-led expansion is preferable to a CPP-led expansion.

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Ensuring Fairness in Public Pension Plans

Introduction

Corresponding to the set of issues related to the private pension system is a similar list of public sector concerns. We shall address some of these in this chapter. At the outset, the Council believes that it is important to recognize once again that there is an important difference between public and private plans. Private plans involve contractual arrangements; public pension plans do not. Thus, when we discuss the appropriate nature of public pension reform we are, in part at least, addressing issues that relate to social policy. This does not make public sector reforms less important than private sector reforms. Indeed, in some cases they are far more important, since the public pension area concerns itself with providing adequate living standards for the elderly. Our only point here is that the solutions can be different because the arrangements and the nature of the commitments are different.

As we have noted on several occasions, pension reform is nowhere more urgently needed than with respect to the income support level for the single elderly. This is also among the more contentious of the public sector reform issues, since it involves the trade-off between universality and selectivity. We shall address this point in considerable detail in Chapter 17. In this chapter, the focus is principally on credit-splitting, disability provisions, and homemakers' pensions. As a guide to the chapter, it is useful to reproduce those areas of concern that the Green Paper has highlighted:

1 No termination of survivor benefits upon remarriage.

2 Extension of current credit-splitting arrangements to reflect the fact that both spouses contribute to and jointly own benefits, by:

- making disability benefits payable to either spouse upon disability;
- providing immediate death benefits on behalf of either spouse;
- providing a split of potential benefits in case of three years of separation;
- providing separate pension benefits when the younger spouse reaches 65.

3 An enhanced package of post-retirement survivor benefits including:

  - a lifetime pension for those over age 65 of 60% of benefits earned at the time of a spouse's death (after credit-splitting);
  - removal of the current limit on combined retirement and survivor pensions.

4 As well, consideration should be given to replacing survivor benefits for those under age 65 with a two-part structure incorporating both a bridging benefit and a lifetime continuing benefit. (pp 57-58)

In addition, the Green Paper proposes to increase disability payments under the CPP so that the flat rate disability benefit is equal to the level of the OAS.

In the Council's view, these are very complex issues in their own right. They are made more complicated by virtue of the fact that the provinces also have programs that affect these various groups.

Survivor benefits and credit splitting

Among the Green Paper proposals for private pension plan reform was the recommendation of a joint and last survivor plan (unless waived) under which the survivor would receive, say, 60 per cent of the joint pension. Under the proposed public sector (i.e., CPP) modifications, there would be full credit splitting and the survivor would receive 60 per cent of the deceased spouse's pension for an overall total of 80 per cent of the joint pension. This seems a bit high to us, particularly since in those cases in which it was the only outside income it would be subject to the 50 per cent GIS tax rate and perhaps the 100 per cent GIS-GAINS tax rate. The principal groups to benefit from this generous rate would be those well above the poverty level.

This conclusion becomes more evident when both partners in a relationship have access to a maximum CPP in their own right, since in this case the combination of a retirement pension and a survivor's pension would, under the Green Paper proposal, amount to a pension of 1.6 times the maximum CPP. Some Council members are not concerned by the fact that one person might be eligible for a 'combined' CPP that is much higher than the maximum single rate. But some are.

At base, the issue is one of whether the CPP should attempt, where possible, to follow 'pension' principles or whether it should become a major 'redistributive' vehicle. Those reforms that relate in some way to the former alternative are easier to assess. For example, the provision for splitting CPP entitlements in the case of three years of separation appears appropriate. We can also endorse the principle that survivors' benefits should not terminate on remarriage.

But even here the issues can become clouded. Suppose that a surviving spouse marries a CPP contributor (i.e., one who is under 65). If the CPP contributor turns 65 and then dies, does the spouse now add a new 80 per cent CPP survivor benefit to the existing survivor benefit? These questions are relatively easy to sort out in a system where contracts exist. They are much more difficult in the public pension arena, which a) is not fully funded in the first place and b) is geared somewhat to redistributive principles. Indeed, there are likely to be no 'correct' answers to many of these reform proposals: they have to be addressed within the broader context of overall public pension reform (including the income support proposals for the single elderly) on the one hand and the range of other social programs on the other.

Consider, for example, the Green Paper proposal that consideration be given to replacing the current benefit structure for under-65 survivors with a two-part benefit consisting of a short-term bridging benefit and a lifetime continuing benefit. On the surface, this may appear to be a reasonable approach. In the broader context referred to above, however, the issue becomes one of how this benefit structure is to be integrated with the benefits from other social programs. Suppose that the surviving spouse is a female with several children. Under current CPP arrangements, the level of benefits is adjusted somewhat to reflect the presence of dependent children, but not enough to prevent the family unit from falling back on welfare if there is no other source of income. The interesting question then becomes: How will this CPP benefit be viewed by the welfare authorities? Will it be offset fully by reduced welfare payments?

One approach to this general issue is to have a single formula for survivor benefits and to have programs such as the Canada Assistance Plan (i.e., welfare) handle any special needs of the surviving family unit. The other approach is to build some 'needs' factors, as it were, into the structure of the CPP survivors' benefits so that the CPP becomes part pension, part social policy. We see problems associated with moving the CPP more in the direction of becoming an instrument of social policy.

In any event, the Council feels that decisions with respect to CPP disability and survivors' benefits have to be taken within the overall social policy context. Towards this end, we would urge the various governments to convene a federal-provincial conference whose purpose would be to discuss and evaluate alternative CPP benefit structures and the manner in which they might best be integrated into the existing set of social programs. If integration is lacking, the fact that survivor benefits under CPP are rather generous may in the final analysis mean nothing in terms of extra income, except to those family units that are already well off and do not have to resort to supplementary support.

Despite our inability to come to definite conclusions with respect to many of these 'fairness' issues in the debate over the public pension system, there is one issue respecting which the Council was able to generate unanimity - homemakers' pensions.

Homemakers' pensions

During the course of the parliamentary hearings on the Green Paper, the issue that attracted increasing attention was that of homemakers' pensions. The argument is that housework has economic value and as such ought to be recognized in the pension system. In more sophisticated terms, housewives deserve 'entitlement' retirement income in the form of CPP pensions rather than 'transfer' income in the form of, say, GIS.

The Council is opposed unanimously to this proposal. Among the many reasons for our adopting this position are the following:

1. The proposal is geared to rewarding housework done by those who remain outside the labour force. There is no equivalent recognition of those women (or men) who are both part of the paid labour force and who are responsible for housework.

2. The cost in terms of payroll levies of providing for homemaker pensions for one-earner families would be considerable. Moreover, because of the interaction with GIS, the benefit in retirement for low income couples would be slight. The chief beneficiaries would be the well-to-do. For well-to-do families, the Council feels that the existing RRSP provisions for spousal contributions are a preferable route.

3. The child-rearing drop-out provision does in fact cover homemakers with children under seven years of age, since it allows spouses to drop out of the labour force to care for young children without suffering a loss of CPP credits. It has for some time been a feature of the QPP and, with Ontario's recent agreement, it will now be incorporated into the CPP.

4. Homemakers' pensions would do nothing for the currently elderly poor, most of whom are single women. Granting homemakers' pensions retroactively to these individuals would not only be expensive; the pensions would not be any different in principle from 'transfer' income and would, therefore, run counter to the rationale for homemakers' pensions in the first place.

Ensuring Fairness in Public Pension Plans: Council Summary Observations

- The Council finds it difficult to assess many of the Green Paper proposals in this area, in large measure because the CPP appears to be moving in the direction of being much more than a pension instrument.

- In principle, we can endorse the idea of CPP credit-splitting. We can also support the provision for splitting CPP entitlements in the case of three years of separation. Likewise, we deem it appropriate that survivors' benefits not terminate on remarriage. On the other side of the ledger, we are opposed to homemakers' pensions.

- Our concern arises in connection with those aspects of the benefit structure that appear to incorporate elements of redistribution as distinct from pension elements. We are concerned that the CPP will move too far in the direction of becoming an instrument of social policy. In our opinion, there exist programs that are better suited to serving this objective.

- The Council recommends that a federal-provincial conference be convened to evaluate the range of possible benefit structures for such items as survivors' pensions and disability pensions and to ensure that these are integrated intelligently within the existing set of social programs, such as the Canada Assistance Plan. Little is accomplished by recommending rather generous survivors' benefits for under-65 spouses only to find out that, for those family units that are forced to fall back on the welfare system, these benefits are fully offset by corresponding reductions in other social assistance payments.

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Pensions, Savings, and the Capital Markets

Introduction

The relationship between pensions on the one hand and savings, investment, and capital markets on the other is among the most important issues in the pension debate. It is also among the most complex. At the outset of the Council's interest in the pension area we were aware that the thrust of the research of the thirteen associations comprising the Business Committee on Pension Policy (BCPP) was the relationship between pensions and the capital markets. Accordingly, our background document devotes less space to this issue than otherwise would have been the case. Nonetheless, portions of the Whalley and Hamilton paper and the entire article by Greg Jump are devoted to the impact of pensions on savings and, more generally, on resource allocation. The first part of this chapter is devoted to a brief (indeed, extremely brief) summary of some of this material. The second part focuses on recent pension growth, both in absolute terms and as a percentage of total savings, and on the asset structure of the various pension plans, private and public. The chapter concludes with some observations relating to the interaction between pensions and the capital markets.

Pensions and savings

Research conducted in the United States tends to argue that public pensions of a 'pure redistribution' type (such as the U.S. social security system or Canada's OAS) impact adversely upon savings behaviour by the household sector. Under such a pay-as-you-go system, contributions to a public sector plan create private wealth in the sense that a claim on part of the incomes of future generations of workers is established. From a social point of view, however, no net wealth addition occurs because no real capital accumulation takes place. Thus, as public pension wealth substitutes dollar for dollar for private sector financial savings, a corresponding reduction in capital accumulation occurs. The implication of this line of analysis is that greater reliance on private rather than public pensions will lead to greater capital accumulation in the economy.

The counter-argument to this analysis is that any intergenerational transfers that are made through the public sector will produce corresponding adjustments in transfers that take place in the private sector, principally through lower bequests from parents to children. To the extent that these adjustments are offsetting, the impact of the social security system on private sector savings nets out to zero. In the American as in the Canadian context, quantitative analysis is available to buttress both these positions.

On balance, the Council believes that in the context of a *closed economy* it is likely to be the case that intergenerational programs such as OAS will depress private sector savings and, hence, capital accumulation.

However, Canada is best viewed as an *open* not a closed economy. The characteristic of an open economy is that domestic savings need not be closely related to aggregate investment, since it is possible to draw upon foreign capital inflows.[1] In the limiting case where the economy is small and open and international capital mobility is perfect (and hence, where real interest rates are determined on world capital markets), investment is *independent* of domestic savings: any domestic savings shortfall will be made up from foreign savings.

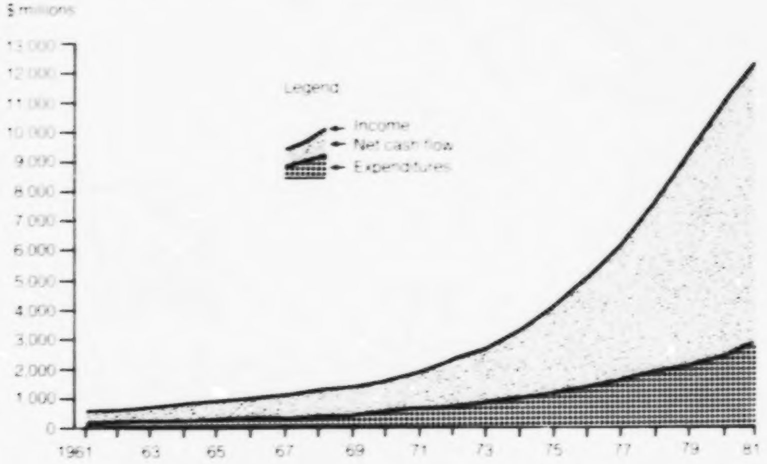
Therefore, under these open economy assumptions, even if the public pension system depresses private domestic savings, this need not result in a shortfall in investment. What a savings decrease will imply, however, is an increased reliance on foreign-source capital. Whether for valid reasons or not, increased foreign ownership is popularly viewed as undesirable. Thus, the savings issue remains a valid concern in structuring the future of the public pension system, and pensions generally.

Unfortunately, the empirical evidence currently available is not sufficiently clear to provide reliable quantitative estimates of these impacts.

The growth of pensions

Table 19 presents an overview of the income, expenditure, and net cash

Table 19
Income and Expenditures of Trusteed Pension Funds, 1961-81



SOURCE Statistics Canada *Trusteed Pension Plans Financial Statistics* (74-201), 1981, Figure III

flow of trusteed pension plans over the 1961-81 period.[2] In 1981, the total income of these plans exceeded $12 billion. Slightly less than half of this income arose from contributions and slightly more than half from earnings on pension assets. With payouts just under $3 billion, the net cash flow for 1981 was in excess of $9 billion.

As a proportion of overall gross savings, trusteed pension savings have also grown markedly - from 7.3 per cent in the early 1960s to 14.7 per cent in 1981-82.[3] Over the same period, total pension savings (i.e., all categories in Table 20, below, except RRSPs) as a proportion of gross savings increased from 11.8 per cent to 23.1 per cent.

These data provide some substance for the view that pension funds are playing an increasingly important role not only in aggregate savings but in terms of their impact on capital markets as well.

TABLE 20

1981 Pension fund asset distribution (based on values rounded to the nearest $billion)

	Debt type assets (%)				Ownership type assets (%) (stocks and real estate)		
	Non-govt.	Govt.-market-able	Govt.-non-market-able	Total	Total	Overall amount $billions	Claims on future generations
Employer plans							
Private sector	40	20	0	60	40	30	0
Public sector I[a]	35	31	17	83	17	29	0
Public sector II[b]	0	0	100	100	0	27	12
Universal plans							
CPP	0	0	100	100	0	20	95
QPP	0	83	0	83	17	6	35
RRSPs	84	4	0	88	12	25	0
						137	142

[a] Trusteed plans (crown corporations, health and educational, provincial and municipal).

[b] Consolidated revenue plans (most federal government plans).

SOURCE: Business Committee on Pension Policy (1983) Capital Markets Study, p. Sum:5 and Table 2.3.

Pensions and capital markets

Table 20 presents further data relating to the interaction between pensions and capital markets. Pension assets in 1981 totalled $137 billion (the second last column). Of this total, RRSPs accounted for $25 billion. Given the recent growth of RRSPs, they will soon assume first place in this classification.

The main purpose of Table 20 is to illustrate the different asset structures of the various pension plans. Private sector plans direct 40 per cent of their investment to ownership-type assets (stocks and real estate). In sharp contrast, the CPP and the public sector consolidated plans have all of their assets in non-marketable government debt. Of particular interest in the table is the difference between the asset structures of the CPP and the QPP. Seventeen per cent of the assets of the QPP are in the ownership-type category, and the remaining 83 per cent are in marketable government debt. The reason why the QPP's bond holdings are classified as marketable is straightforward - the QPP buys bonds on the open market and earns market returns. This is not true of the CPP, as was elaborated in Chapter 4 - the CPP invests in 'non-marketable' provincial government bonds. They are 'non-marketable' in part because the interest rate on them is set equal to the rate on federal government bonds and not at the rate on marketable provincial bonds.

The final column of Table 20 focuses on the unfunded liabilities, or the claims on future taxpayers, that have already been generated under the various pension plans. The total, in 1981 dollars, of $142 billion is somewhat larger than the accumulated value of all existing pension assets. Obviously, the trusteed plans (the private sector and public sector categories) and RRSPs imply no claim on future generations. Not surprisingly, the overwhelming portion of unfunded liabilities arises from the operations of the CPP/QPP. Significantly increasing the public sector pension system under current arrangements would increase these unfunded liabilities in a roughly proportional manner. As elaborated earlier, this passing-on of pension costs to future generations, adding to their already daunting burden, is one reason for the Council's decision to argue against any further public sector pension expansion. Moreover, the date in Table 20 does not include the unfunded liability of the OAS, which would easily exceed that of the combined CPP/QPP.

In summary, it is clear from Table 20 that much is at stake for capital markets in the pension debate. In particular, reform spearheaded by an improved and enlarged private pension system would have capital market implications diametrically opposed to those that would follow from an expanded CPP. This relates both to the distribution of any fund assets and to the degree of intergenerational transfers.

Regulating capital markets

The rapid growth of pension funds raises the possibility that these funds will eventually play too dominant a role in the nation's markets for capital. At present, there is not really a problem. The data underlying Table 20 indicate that, as of the end of 1981, pension funds had some $17 billion invested in equities. In contrast, individual Canadians held over $100 billion in equities. Nonetheless, pension capital pools, both private and public, are large and, as noted above, likely to get much larger.

Does this pose a potential problem in terms of a concentration of power in the form of capital market dominance and/or control? This issue came to the fore recently in connection with Bill S-31, The Corporate Shareholding Limitation Act. The explicit purpose of the Bill S-31 is to curb the investment strategy of the Caisse de dépôt et placement and other Quebec crown corporations. More generally, the bill would have implications for large provincial pools of capital such as the Caisse and Alberta's Heritage Fund, in terms of the accountability of such institutions and the role of provincial governments in the direction of economic decision-making in the economy.

While Bill S-31 refers to pools of public sector capital, the issue at hand is clearly more general than this. What ought to be the regulations governing the investment strategy of pension funds, private and public? The current investment regulations governing the Caisse (which manages the assets of the QPP) stipulate that it cannot hold more than 30 per cent of the common stock of a single firm, nor can its overall equity portfolio exceed 30 per cent of its total assets. Ontario's Pension Benefits Act, which applies to occupational plans, stipulates that a) no one investment can constitute more than 10 per cent of the total fund value and b) no fund can hold more than 30 per cent of the common shares of a single corporation. In other words, the legislation relating to pension fund investment strategy, public and private, is broadly similar across the country.

Is the 30 per cent figure too high, given that 30 per cent ownership would probably ensure effective control of a broadly based corporation? One alternative would be to allow 30 per cent ownership for widely held companies if the pension fund so desired but to limit the voting rights of pension boards to 10 per cent.

Clearly, these issues deserve much wider discussion, even though they were not really highlighted at all by the Green Paper. The Council believes that some version of the above limits would be appropriate as a means of regulating pension funds. Moreover, the Council believes that these limits ought to be applied uniformly to private and to public pension funds.

To the extent that RPAs became a widely used pension instrument the power of private pension funds would tend to be diluted, since the RPAs would be managed by individuals. At least the individual would have the freedom to a) choose between alternative institutions to run his plan and/or b) allocate his accumulated savings among fixed income, market, and equity instruments.

Finally, it is interesting to note that the authors of the Green Paper also voiced some concerns relating to the interaction among pensions, savings, and the capital market:

> Enlarged mandatory arrangements could also result in fundamental changes in the ways savings accumulated to fund enlarged pension benefits are channelled into productive investment. These changes could have repercussions throughout the economy, since savings and investment decisions lie at the heart of economic performance. The size and composition of Canada's capital markets could be altered considerably. For instance, an expansion of public plans would likely displace a portion of private and public employer-sponsored pension plans. This would change where funds are initially accumulated and in turn could alter the use to which the funds would be put. As well, the degree of funding of expanded mandatory plans could affect the availability of investment capital. (p. 50)

The Council agrees with this account of the sorts of resource-allocation and capital-market implications that are at stake in the pension debate. Though the empirical literature relating to these issues is rather inconclusive, it is clear nonetheless that alternative approaches to pension reform have vastly different implications for the functioning of capital markets and for the role of government in the economy.

Pensions, Savings, and the Capital Markets: Council Summary Observations

- The impact of pensions, particularly OAS-type pensions, on savings and capital has been the subject of considerable economic literature. The initial view that the public system would substantially reduce savings is now being questioned. What is clear, however, is that pension arrangements affect the channels through which individuals save, which in turn influences how the accumulated pools of savings are invested.

- Even if private savings do fall as a result of a public pension system, in an open economy this need not imply that investment or capital accumulation will correspondingly decline. However, what it does imply is that a decrease in domestic savings will be offset by an inflow in foreign savings.

- Pension funds comprise a large and growing share of savings and capital. As of 1981, the accumulated assets of pension funds amounted to $137 billion. However, the unfunded liabilities of public plans were even larger - $142 billion. This figure excludes the unfunded liabilities of non-contributory pensions such as the OAS.

- The different types of pension funds have dramatically different asset portfolios. For example, the Consolidated Revenue Plans (e.g., federal employee's pension plans) and the CPP have 100 per cent of their (partially funded) assets in non-marketable government bonds. In contrast, the QPP has 83 per cent of its assets in marketable government debt and the remainder in ownership-type assets, whereas employer plans in the private sector have 40 per cent of their assets in equities, 40 per cent in non-government financial instruments, and

20 per cent in marketable government debt.

- Regulations concerning pension fund investment limit equity participation to 30 per cent of the common stock of any firm. This general area of pension dominance and control needs more study, particularly in light of Bill S-31. The Council is of the opinion that private and public sector investment regulations should be on an equal footing. Neither public nor private pension funds should be allowed to have a dominating position in capital markets, nor should they be able to influence significantly the direction of economic decision-making.

- The RPAs, since they are managed by individuals, may serve a role in terms of diffusing the power and influence of the large private sector pension pools.

17
Pensions and the Current Elderly

Introduction

The Council has identified the income situation of some segments of the current elderly as the immediate priority in the pension arena. However, most of the pension proposals are designed to have their principal impact on future generations of pensioners. Some of these proposals would ensure that the future elderly fared better. For example, to the extent that some single elderly find themselves below the Statistics Canada low-income cut-offs because survivor benefits are inadequate, credit-splitting and the provisions for survivors would ameliorate this cause of low income among the elderly in the future. To the extent that lack of pension inflation protection is responsible for the income shortfall, the excess interest proposal could remove this source for future pensioners. To the extent that the current elderly do not have sufficient access to pensions because of existing vesting and portability arrangements, the set of proposals elaborated above would improve pension access for the coming generation of senior citizens. And so on.

However, none of these initiatives do much to sort out the problems affecting the current elderly. These problems include:

- The level of income support for the single elderly relative to that for married couples and, what is more important, the likelihood that the absolute level of single elderly support is too low.

- The very high (at times confiscatory) marginal tax rates that apply to outside income for those receiving GIS and GAINS, which in turn diminish the incentives for low-income persons to save for their retirement years.

- The integration of provincial and federal support systems, which, in the case of Ontario, serves to exacerbate the above two problems.

These issues provide the basis for the present chapter.

It might seem appropriate to deal with the current and future elderly completely separately that is, to focus on the current elderly principally in terms of social policy or pure redistribution criteria and to deal with the future generation of pensioners in terms of system reform, in which case the emphasis would be more on 'pure pension' or income-replacement issues. While there is some merit in this distinction, it is not the approach that we have adopted in this study. Moreover, the manner in which one sorts out the concerns associated with the current elderly will influence the manner in which the income support component of the public pension system interacts with the replacement component in the future.

The GIS solution: pros and cons

The income support problem for the current elderly is not an 'across-the-board' problem that affects all segments of the retired. Hence, target efficiency suggests that the appropriate cost-effective solution may be one that is selective rather than universal, i.e., a targeted rather than an across-the-board measure. This is why many individuals and organizations are calling for an increase in GIS rather than an increase in, say, OAS as a means of enhancing the income levels of the single elderly.

There are several advantages to this approach. First, the money would go to those who needed it most and only to them. Second, the GIS can be allocated on a differential basis between single and married couples, whereas OAS, being universal, cannot be so restructured. Thus, an increase in the basic OAS level in order to bring singles up to, say, Statistics Canada's low-income cut-off levels would imply raising the support level for couples by twice this amount. Third, while GIS is income tested (not means tested), there is very little stigma attached to GIS payments. As one of the federal background documents notes, the cheque to the single person would be such that 'even the bank teller' would not know that it was a GIS payment. Fourth, in a period of general fiscal pressure, it seems to make sense to go the selectivity route. Even the impression coming from Ottawa appears to be that payments to the single elderly will increase as soon as the fiscal position allows. For a given freeing-up of funds, more can be accomplished in terms of meeting the needs of the single elderly if the approach is selective (GIS) than if it is universal (OAS).

However, there are also several problems associated with increasing GIS. Economist Jonathan Kesselman of the University of British Columbia highlighted many of these problems in his recent paper 'Pitfalls of Selectivity in Income Security Programs.'[1] Among the points stressed by Kesselman is that a GIS-type selective approach is likely to create both equity and efficiency problems. For example, the tax-back rates for other income typically become relatively high under a selective approach. We have alluded to this point on many occasions in this report. Indeed, the profiles of tax rates for the elderly, which appear in Tables 21 and 22 below, provide clear evidence that the elderly face very high marginal tax rates. A second problem, again highlighted on several occasions, is that these high tax-back rates provide a substantial disincentive for setting aside retirement income. Indeed, the problem is even more complicated. To the extent that persons do accumulate some retirement income, but not enough on an annual basis to exceed the GIS threshold, there will be a near-irresistible tendency to manipulate these savings so as to escape confiscatory taxation. At one extreme, 64-year-olds could embark on a spending spree or invest these funds in things, such as summer cottages, that will not be an offset to GIS. Alternatively they could arrange to bunch the timing of any outside income so that it accrued in sufficient quantity - say, every third year - to well exceed the GIS threshold. At the other extreme, pensioners could simply give their accumulated assets to their children in return for annual (non-reported) remittances. The point is simple - when marginal tax rates are as high as 50 per cent, let alone 100 per cent, there is an incentive for tax avoidance and perhaps even tax evasion. This is well documented for many segments of the population and there is no reason why it should not hold for pensioners as well.

In short, there is a dilemma here. Perhaps it is not too surprising that it should arise. The public pension system is designed to achieve several goals - income support, income replacement, fairness. However, there are also limits on the fiscal resources that can be allocated to public pensions. It may well be inevitable that the pursuit of these often-conflicting goals will result in arrangements that generate the problems we have described.

The Council's position is that under existing arrangements the GIS route, albeit beset by problems, is the appropriate route to take. Nonetheless, the issues here are so complex that the Council offers for further consideration several proposals that may provide a better answer. However, since these proposals involve some, and often considerable, alteration of the status quo, they are not to be construed as specific recommendations.

The tax system and the elderly

To provide some needed background to the general area, it is instructive to review the manner in which the income taxation system affects the elderly. The emphasis is as much on average tax rates as it is on marginal rates, since the former present the true picture of the overall tax-transfer position of the elderly.

Table 21 presents the current taxation position for the single elderly. An Ontario senior citizen without any outside income received $6,871 in income in 1982. This includes OAS, GIS, GAINS, and the Ontario Tax Grant of $590.

The first column of the table presents the level of other income or outside income received by the single pensioner. In turn, the various columns focus on marginal tax rates, transfer income, after-tax income, and average tax rates for pre- and post-retirement. The marginal tax rate on the first $1,173 of outside income is 100 per cent, reflecting the confiscatory nature of the GIS-GAINS combination. However, at this income level, the average tax rate is -486 per cent, i.e., the pensioner's after-tax income is 4.86 times his outside income.

Next, consider a pensioner with $10,000 of outside income. At this point, the marginal tax rate is the same for the 65-year-old as it is for the 64-year-old, i.e., 26.64 per cent. In other words, both GAINS and GIS have been reduced to zero so that the pensioner is on the regular tax schedule. Transfer income is reduced to $3,432, which is the sum of OAS and the Ontario refundable tax credit. At $10,000, the average tax rate is still -23 per cent. In other words, the after-tax income of the pensioner ($12,306) is still 23 per cent higher than his outside pre-tax income.

The crucial point in the table is that the average tax rate remains negative even at rather high income levels. Consider an outside income

TABLE 21
Taxes/transfers for single Ontario residents aged 64 or under (64-) and 65 or over (65+), 1982

Outside income	Marginal tax rate		Transfer income[a]		After-tax income[b]		Effective tax rate		Net value of OAS	Net value of special deductions
	64-	65+	64-	65+	64-	65+	64-	65+	65+	65+
$0	-	100%	$4,235[c]	$6,871	$4,235	$6,871	-	-	$2,842	$0
$5,000	0%	50%	$335	$3,784	$5,335	$8,784	-6.7%	-76%	$2,842	$0
$10,000	26.64%	26.64%	$0	$3,432	$8,918	$12,306	11%	-23%	$2,049	$894
$15,000	28.12%	28.12%	$0	$3,432	$12,436	$15,910	17%	-6%	$2,001	$950
$20,000	34.04%	34.04%	$0	$3,432	$15,853	$19,415	21%	3%	$1,876	$1,096
$25,000	37%	37%	$0	$3,432	$19,113	$22,685	23.5%	9%	$1,791	$1,191
$50,000	44.4%	44.4%	$0	$3,432	$33,738	$37,338	32.5%	25%	$1,580	$1,430
$100,000	50.32%	50.32%	$0	$3,432	$58,994	$62,617	41%	37%	$1,413	$1,620

a Transfer income includes Ontario Tax Credits and Ontario Tax Grants for Senior Citizens.

b Basic personal exemption and standard deduction only deductions assumed for 64- taxpayer with old age exemption and full pension deduction added for 65+ taxpayer.

c $4,235 = social assistance payments made to unemployable single resident of the City of Toronto plus estimate of refundable Ontario Tax Credit.

level of $15,000. The marginal tax rate facing the pensioner is 28.12 per cent. However, the average tax rate is minus 6 per cent, implying that the pensioner's total income equals the other income of $15,000 plus $910 (i.e., $15,910). The break-even level is where the pensioner pays in taxes a sum equal to the income support level of $3,432, i.e., the income at which the pensioner is 'even' with the income taxation system. This occurs at an income level of $18,778. In other words, a pensioner with outside income of $18,778 would also have an after-tax income level of $18,778. This 'break-even level' is a minimum estimate, since we have assumed that our hypothetical elderly taxpayer in Table 21 claimed no other deductions aside from the basic personal exemption, the old age exemption, the standard deduction, and the full $1,000 pension deduction.

A single taxpayer aged 64 with an income level of $18,788 would have an after-tax income of just over $15,000, roughly $3,432 lower than the pensioner. This tax differential in favour of the pensioner will remain as outside income rises, as the after-tax column illustrates.

The situation for an elderly couple is portrayed in Table 22. The minimum break-even level for a couple, defined as above where their tax payments offset OAS plus Ontario tax credits, can be shown to equal $30,107. The net tax bill for this same couple, at age 64, would be $6,324. Table 22 assumes that the outside income accrues to one spouse. If it accrued equally to both, the minimum break-even level would be in the neighbourhood of $37,000, that is, roughly double the break-even level for a single elderly person.

This raises a rather delicate issue, but one that has to be brought into the public debate. The typical discussion of the situation of the elderly makes the point that they often find themselves in difficult economic straits. No doubt this is true, as we have elaborated throughout this document. However, there is also a problem on the other end of the income spectrum. It is difficult to accept the notion that single elderly persons with $18,000 of outside income and couples with $30,000 or $38,000, depending on whether this income accrues to one or both spouses, ought not to pay any net income taxes. In this sense, the overall tax/transfer treatment of the upper-income elderly is too generous.

Herein lies the dilemma. Universality in terms of income support for the elderly generally implies substantial subsidies to the elderly wealthy. Selective (or income-tested) benefits generally imply very high tax-back rates for the lower end of the income spectrum. What are the potential

TABLE 22
Taxes/transfers for Ontario married couples aged 64 or under (64-) and 65 or over (65+), 1982

Outside income	Marginal tax rate		Transfer income[a]		After-tax income[b]		Average tax rate		Net value of OAS for 65+	Net value of special deductions for 65+
	64-	65+	64-	65+	64-	65+	64-	65+		
$0	-	100%	$6,540[c]	$12,544	$6,540	$12,544	-	-	$5,684	$0
$5,000	0%	50%	$335	$8,224	$5,335	$13,224	-6.7%	-164%	$5,684	$0
$10,000	26.64%	26.64%	$0	$6,324	$9,823	$15,990	11%	-60%	$4,311	$1,451
$20,000	29.6%	29.6%	$0	$6,324	$16,809	$23,225	16%	-16%	$4,041	$1,735
$30,000	37%	37%	$0	$6,324	$23,413	$29,852	22%	0.5%	$3,786	$2,013
$50,000	44.4%	44.4%	$0	$6,324	$35,119	$41,580	30%	17%	$3,404	$2,415
$100,000	50.32%	50.32%	$0	$6,324	$60,561	$67,039	39%	33%	$3,101	$2,737

[a] Transfer income includes Ontario Tax Credits and Ontario Tax Grants for Senior Citizens.

[b] Assumed deductions same as in Table 21 with additional assumption that one spouse has no income aside from OAS.

[c] $6,540 = social assistance payments made to unemployable married couple in the City of Toronto plus estimate of refundable Ontario Tax Credit.

ways out of this dilemma? To this issue we now turn.

Alternative approaches to income support

Provincial targeting

At the margin, the provincial governments could top up the federal income support in a more targeted manner. For example, if elderly renters living alone are most in need, the provincial programs could meet this need directly, rather than provide GIS-type supplements that carry 100 per cent tax-back rates, or universal benefits that make no meaningful distinction between elderly homeowners and renters. And, to a degree, the provinces do this. The difficulty here is that the system would gravitate toward needs-tested supplements rather than income-tested supplements, which would be of concern to many segments of the population. There is no question, however, that there is considerable scope in the existing provincial programs for this sort of targeting.

The old age exemption

A second alternative could be to eliminate, or preferably phase out, the special tax exemptions for the elderly, namely the current $2,360 age exemption and the $1,000 pension income exemption. The combined effects of making OAS taxable and introducing these special exemptions essentially offset one another. In effect, this converts OAS into a non-taxable benefit, which in turn means that all pensioners regardless of income status receive the full value, tax free, of the OAS.

To be sure, there probably is some rationale for these exemptions. For example, their existence means that persons who qualify for partial GIS are not subject to income tax in addition to the 50 per cent GIS tax-back rate. Eliminating the exemptions would make some partial-GIS recipients subject to the regular income tax and raise the marginal tax rate to somewhere near 75 per cent - 50 per cent from GIS tax-back and the remainder from the initial income tax rates.

Despite this important proviso, which would have to be sorted out, a strong argument can be made for phasing out these tax exemptions. Such a modification would have its principal impact on the high-income elderly, as is clear from the last column of Tables 21 and 22. As the background paper by Adil Sayeed suggests, this alteration in the income tax scheme of and by itself would probably free up enough funds within the public pension system to permit the topping up of GIS for the single elderly.

A separate tax schedule for the elderly

A more dramatic alteration would be to develop a special tax system for the elderly, largely designed around negative income taxation lines. One approach to such a scheme would be as follows. The basic income support level for single and married elderly would be in the form of universal, non-taxable entitlements. Presumably, the income support level would be such as to satisfy the needs of singles and couples; e.g., the support for singles might be raised to the Statistics Canada low-income guidelines. Unless the elderly were responsible for looking after other individuals (e.g., disabled relatives) there would be no exemptions allowed. Each dollar of outside income would be taxed at a flat rate of, say, 30 or 35 per cent until this tax system intersected the tax system utilized by the rest of society; i.e., the flat rate of 30 or 35 per cent would prevail until the marginal tax rate of the existing tax system for the under-64 age group also equalled 30 or 35 per cent. From this point onward, the seniors would follow the regular taxation system. The flat rate would be chosen so as to ensure that at some acceptable level of outside income, such as the average industrial wage, the tax treatment of the elderly would be such as to place them in the same net-of-tax position as those with similar income who were under 65.

This system has several advantages. First, the maximum marginal tax rate for lower income individuals or families would be 30 per cent (or perhaps 35 per cent), rather than the 50 per cent under GIS or the 100 per cent under GAINS-GIS. This would, relative to the existing system, increase the incentive to save for retirement and reduce the incentive to hive off outside income because of confiscatory tax rates. Second, the income support level would be essentially a universal entitlement which, like OAS, could be payable monthly. Therefore, there would be no stigma at all attached to the payments. Pensioners would initiate the tax-back by filing a regular income tax form. Third, all pensioners would be at least as well off as their counterparts under 65 with equivalent outside (earned) income. Indeed, up until the income level where the two tax systems merge, pensioners would be better off. Fourth, within the pension group, however, there would be a transfer from higher income segments to lower income segments. After some income level, the 30 per cent flat rate means that pensioners under this alternative system would be worse off than they are under the current arrangements. But this is exactly what has to happen if one believes that the overall tax treatment of the higher income elderly is too generous. For this reason any such proposal would have to be phased in gradually. On the negative side of the ledger, in addition to the above point about some losers vis-à-vis the existing arrangements, there is the more general concern that this arrangement would represent a considerable departure from the status quo. Moreover, the mechanics of the suggested approach are probably very complex. It may not be easy to come up with an integration of the two systems that is symmetrical with respect to both single and married elderly.

Greater access to tax assistance

Consistent with any or all of the above alternatives is the option to allow low-income persons to take greater advantage of tax-assisted pension savings if their income levels rise. In other words, one might conceive of a lower bound for contribution to RRSPs, RPAs, and the like to which all Canadians would be entitled. If their incomes rose in later years, they could exceed the annual contribution limits in order to bring their lifetime contributions up to some minimum level. An alternative scheme would be to provide the option, with respect to RRSP contributions, of allowing the higher of either the existing tax-deduction approach or a refundable tax-credit approach. This would provide an offset to the currently high GIS tax-back rate.

Recapitulation

These, then, are some of the options that merit further investigation. There is no question that some of these alternatives represent a major departure from the status quo. Correspondingly, there is also no question that some elements of the status quo need restructuring.

Suppose one were to go to a full-blown negative income tax for the elderly. What then would be the role for the Canada Pension Plan? To the extent that it would have a role, it would presumably be geared to the income replacement function. One would want to purge from it most 'redistributive' aspects and put it on an actuarial basis. Or at least this would be one approach to the CPP in the context of a negative income tax system for the elderly. In other words, if one were able to sort out in an intelligent manner some aspects of the overall pension system, some other aspects would also fall into line. Part of the problem with the current arrangements is that each of the components of the system appears to be directed toward multiple goals, with the result that the system becomes increasingly complex and disincentive-ridden.

While we have not researched these alternatives well enough to offer them as recommendations, we urge strongly that they be the subject of future research and investigation.

The Council recognizes that some problems will arise if the income support aspect of the overall pension system moves away from universality and towards a more selective approach. However, unless and until society is willing to consider, say, a negative income tax approach or some other alternative, a majority of Council members are of the opinion that any attempt to increase the income support levels of the current elderly should proceed along GIS lines. Almost any other scheme within the existing arrangements would be both more costly and less likely to be directed to those most in need.

Pensions and the Current Elderly: Council Summary Observations

- Most pension reform proposals evaluated thus far would have their principal impact on future pensioners. This still leaves unresolved the situation of the current elderly.

- The income support shortfalls for the current elderly are not an across-the-board concern. This suggests that the cost-effective solution is likely to be selective rather than universal.

- Under present arrangements, selectivity effectively means GIS.

- However, the overall income support system for the elderly needs rethinking. At the low end of the income scale, pensioners are confronted with 50 per cent and often 100 per cent marginal tax rates. At the higher income levels, they are probably treated too generously: an elderly couple receiving $38,000 of other income (beyond OAS) 'breaks even' with the government, paying no net income taxes.

- The Council recommends that consideration be given to designing a new tax schedule for the elderly, preferably along negative-income-tax lines. One such variant might incorporate universal income support (payable monthly like OAS) with a tax-back rate of, say, 30 or 35 per cent until the recipient merges with the regular taxation system.

- In conjunction with the above point, The Council also recommends that consideration be given to phasing out the special tax exemptions for the elderly. As Tables 21 and 22 indicate, the benefits arising from these tax advantages increase with income.

- The 'fairness' objective of pension reform also suggests that low-income persons ought to have greater access to tax-assisted retirement savings. The Council offers two suggestions in this regard: first, allowing a refundable tax credit in lieu of a tax deduction for contribution to RRSPs; second, allowing a minimum lifetime contribution to tax-assisted saving schemes, such as RRSPs and RPAs, that all persons are entitled to.

- Under a restructured delivery system, many of the problems that beset current reform proposals would not exist. In other words, part of the problem with the current arrangements is that many of the components of the system appear to be directed toward multiple goals, with the result that the system becomes increasingly complex and disincentive-ridden.

- Without some such modifications in the income support delivery system to the elderly, the Council is of the opinion that any additional support to those segments of the elderly currently in need will have to be along GIS lines.

18
Financing Pensions: The CPP Repayment Schedule and the Retirement Age

There are two further issues relevant to the current pension arrangements that warrant special attention. Both are related to the overall financing of pensions. The first of these is of immediate concern: where do we go from here in terms of financing the CPP? In particular, what can or may be done about the present provincial indebtedness to the CPP? The second is longer-term in nature but potentially far more important: what is the appropriate retirement age?

The CPP repayment schedule

Earlier in the document we defined three so-called 'critical years' in terms of the status of the CPP fund. The first of these will occur sometime within the next two years, when the flow of current contributions equals the flow of current benefits. Beyond this point, unless there is an increase in contributions, the provinces will have to deliver to the CPP fund some of the annual interest owing in order to cover the annual cash-flow shortfall. Because the interest actually paid will be less than the total interest owing, the overall amount of provincial indebtedness will continue to grow. Critical year 'two' will occur in the early 1990s, when the cash-flow shortfall will require the provinces to pay the full interest on their outstanding loans, again assuming no increase in contribution rates. At this point, the provincial indebtedness will be at its maximum. Beyond this point, the provinces will have to draw down their indebtedness to the fund in order to meet the cash-flow requirements. The third critical year will occur around the turn of the century, when the CPP fund is exhausted and the system is forced to rely on higher contribution rates (or decreased benefits).

Thus the financing issue is really one of trading off fund repayments by the provinces with increases in contribution rates. Our earlier analysis suggested that requiring the provinces to repay their loans from the CPP may not differ that much from an increase in contribution rates, since the provinces will probably be forced to raise taxes in order to facilitate the repayment.

It is likely that the provinces will favour an immediate increase in contribution rates, while the federal government will likely favour some drawdown on provincial indebtedness. Since there are multiple vetoes in the operation of the CPP (see the next chapter), some compromise will have to be struck.

One intermediate solution that initially struck us as appealing would be to require that the provinces begin to pay some of their interest owing into the annual operations of the CPP. This payment could be 10 per cent the first year, increasing by 10 per cent each year until the provinces were required to pay the full interest owing. In terms of the overall indebtedness of the fund, this schedule of interest payments would mean that the size of the fund would increase by successively smaller amounts until it reached a maximum when full interest payments were due

Interesting as this proposal may be on the surface, further analysis reveals that there is a basic problem with it and likely with many other possible approaches to the provincial indebtedness. The problem has to do with ensuring fair treatment of the QPP. Consider again the proposal to exact interest but not principal payments from the CPP provinces. This would amount, in the present context, to something like a $25 billion 'gift' to the nine provinces. However, since Quebec maintains responsibility for paying its own QPP pensions, there would be no similar 'gift' to Quebec. Equitable treatment would require that Ottawa take over the responsibility for paying the QPP benefits. Would Quebec permit this? If not, then the proposal represents inequitable treatment across provinces.

If Quebec insists on maintaining its own public pension system, as it is likely to do, and it begins to run down its 'fund' to pay for these pensions, then it would appear that the other provinces would also have to run down their 'funds', i.e., repay some of the principal. A third option, of course, would be for the nine provinces to follow Quebec's lead and 'patriate' their respective CPPs.

Obviously, this is a very complex issue. One possible alternative is for the system to revert to pay-go immediately; that is, to raise annual contribution rates to levels that cover the annual benefits. This would leave both the CPP and QPP funds 'intact', as it were.

It seems clear to us that this trade-off between raising contribution rates and running down the existing CPP/QPP funds will, in the final analysis, have to be sorted out within the overall context of federal-provincial relations, especially since (as the following chapter will make clear) the responsibility for raising contribution rates rests, in a complex way, with both levels of government.

If the decision is made to increase contribution rates in the immediate future, the possibility exists that there will again be excess funds, i.e., that contributions will exceed benefits. A majority of Council members believe that any such excess funds should not be turned over to either the provinces or the federal government. Rather, a separate fund should be constituted and its investment overseen by both government and the private sector. Since the present generation already receives a subsidy in terms of the current operations of the CPP, there is no point in imposing further hardship on future generations by investing the fund in long-term Canada's (or their equivalent), which, over the recent past, have generated a yield that is less than the rate of inflation (a negative real yield). This is in addition to our earlier point that it is inappropriate to treat future pension funds as a means of financing the general operations of government. However, this too is a matter to be hammered out in the federal-provincial financial arena.

Retirement age

Surprisingly, the issue of whether or not to raise the retirement age is not even addressed, let alone evaluated, in the Green Paper. Yet the age-of-retirement question has been central to the debate on social security in the United States. We have no hesitation in asserting that the issue will become important in Canada as well.

The age of retirement is obviously the pivotal point in the relationship between benefits and contributions. Postponing retirement means that people have a longer period in which to make contributions to a pension plan. The effect of lengthening the pay-in period is to reduce the annual contributions for any given level of benefits, other things being equal. But other things are not equal. Postponing retirement also means that life expectancy after retirement is correspondingly reduced. This, too, will have a major effect on pensions. In particular, the reduced post-retirement life expectancy means that any given pension accumulation can buy a larger retirement annuity.

The purpose of this section is to demonstrate that these impacts can be very large. We shall briefly discuss the implications of changing the retirement age for both the public and the private pension systems.

The public pension system

The background paper by Whalley and Hamilton points out that if life expectancy, conditional on reaching age 20, were 75 years (averaged over males and females), then raising the qualifying age for access to the public pension system from 65 to 66 would save approximately $1 billion in 1983 dollars. Each additional year that retirement were postponed would generate proportionally greater savings; i.e., raising the age to 67 would save an additional sum greater than $1 billion. Needless to say, if pressures for providing more funds to the elderly intensify, future governments will take a hard look at the issues surrounding the selection of the retirement age.

Private sector pensions

In a forthcoming publication, the Society of Actuaries evaluates the impact that deferred retirement has on the cost of a pension plan. Motivating the paper were certain legislative developments in Canada and the United States relating to the provision of retirement benefit credits to employees who defer retirement. In particular:

> In Canada, legislation effective April 1, 1982, in the Province of Quebec effectively prohibited mandatory retirement. Although an employee can draw a portion of his benefit from normal retirement date in order to compensate for any reduction in earnings, in most cases employees taking advantage of the law will defer their whole pension to actual retirement date or age 71 if earlier (when the federal tax authorities require that the pension commence). The Quebec law specifically considers the effect of postponed retirement and requires that the pension be 'revalorized.' It is still too early to tell what 'revalorization' formula will be adopted, and which ones will be acceptable to the Quebec Pension Board.[1]

Table 23, adopted from Tables 1 and 2 of this forthcoming study, presents the results of deferring pension entitlement for those who have 35 years of pensionable service. Underlying the calculations is an assumption that if the pension is deferred, the benefits paid will be increased by 3

TABLE 23
The impact of deferred retirement

Age of retirement	Cost-saving for pension plan 6% Interest	8% Interest	Equivalent pension increase 6%	8%
65	1.00	1.00	$100	$100
66	.9208	.9070	$109	$110
67	.8444	.8192	$118	$122
68	.7710	.7367	$130	$138
69	.7008	.6595	$143	$152
70	.6339	.5876	$158	$170

SOURCE: The 1982 Society of Actuaries' Pension Committee (forthcoming) 'Effect of deferred retirement on pension plan liabilities and costs'. Transactions: Society of Actuaries. The last two columns have been added by the Council.

per cent each year, not compounded, from what they would otherwise have been. Hence, if a person was due to receive $100 per month at age 65, he would receive $115 dollars if he retired at age 70.[2] The figures in the table are indexed in terms of the costs or benefits for retirement at 65. Thus, deferred retirement at age 66 means that the cost to the pension plan earning 6 per cent will be 92 per cent of what it would have been for retirement at 65, and the cost will fall to roughly 91 per cent if the fund earns 8 per cent. The final two columns in the table are not in the original document. They are designed to show the equivalent annual pension increase (above the 3 per cent increments) that could be purchased as a result of deferred retirement.

The implications are clearly quite dramatic. Postponing retirement until age 70 costs the pension fund only 58 per cent (for 8 per cent earnings) of what it would have to pay given retirement at age 65. Likewise, the equivalent pension increase is $170, compared with $100 at age 65.

The careful reader will note that the issue addressed in Table 23 is not quite the same as asking what would happen if pension plans matured at age 70. This is because Table 23 does not incorporate additional contributions to the fund beyond age 65. These additional contributions would magnify the increases in the last two columns of the table.

The essential point being made here is that the choice of retirement age has an immense impact on the overall pension system, private or public. As a matter of interest, it would appear to be relatively simple to alter the retirement age under a money purchase (i.e., defined contribution) plan. It is a much more complex exercise for defined benefit plans.

The Council is aware that altering the retirement age has implications that go well beyond those relating to pensions. However, it is relevant to point out that the age of retirement in Canada (for OAS, etc.) was lowered in the late 1960s from 70 to 65. Since then, life expectancies have also risen. It is also interesting that the U.S. Congress has recently raised the retirement age for social security first to 66 and then to 67, in each case phasing in the change over a number of years.

Financing Pensions: Council Summary Observations

- One of the early decisions to be made on the public pension front is whether the rising CPP/QPP benefit payouts are to be met by increased contributions or by having the provinces reduce their indebtedness.

- This decision is made more difficult by the coexistence of the CPP and QPP. Whatever solution is adopted, care must be taken to ensure that there is fair treatment between the two plans. The choice of a solution is further complicated by the fact that both levels of government have a say in the level of contribution rates.

- If contribution rates are raised and the monies thus generated exceed the annual benefit payouts, it is the Council's view that these excess CPP funds should not be turned over to the general revenues of either Ottawa or the provinces. Rather, a separate fund should be constituted, with representatives from both government and the private sector, to oversee the investments. Future generations will already be called upon to pay for more than their fair share of pensions. Investing any excess fund proceeds in assets that earned well below private pension fund earnings (as is the case under the existing CPP arrangements) would only exacerbate the transfer of cost to future generations. This consideration is in addition to our earlier point that it is inappropriate to divert pension surpluses into current fiscal operations.

- Although the age of retirement received little or no attention in the Green Paper, it is one of the pivotal variables in the overall pension equation.

- Raising (or lowering) the age of retirement by one year under current arrangements would mean an annual saving (or cost) of approximately $1 billion 1983 dollars for the public pension system.

- Raising the age of retirement in private plans would also have a dramatic impact on contribution and/or benefit levels. Consider an increase in the retirement age to, say, 67. For the same contribution rates, benefit levels can be increased significantly. This occurs because a) contributions are made over a longer working life, b) fewer people reach the age of retirement, and c) the life expectancy after retirement is reduced by two years.

- A similar set of observations is applicable to the public pension system, among them the observation that a rise in the retirement age would increase the ratio of workers to retirees.

- The Council notes that the age of retirement under the U.S. social security system will gradually increase from 65 to 67 years.

- More generally, a trend in some countries toward raising the age for retirement for public pensions appears to be combined with a desire on the part of some individuals to take advantage of early retirement. This suggests that the overall system should move towards increased flexibility. In spite of the fact that most Canadians are members of defined benefit plans, it seems clear that defined contribution plans (whether the existing money purchase occupational plans or the proposed RPAs) offer the greater degree of flexibility.

- We repeat our disappointment that the issue of the appropriate age for retirement did not assume a larger role in the Green Paper. Its critical role in the overall pension arrangements will not be ignored by future generations of taxpaying Canadians.

Part V

Pension Reform: Federal-Provincial Implications

19
Pensions and the Division of Powers

Introduction

Thus far, our analysis has proceeded without much reference at all to the political environment within which, ultimately, pension reform will have to be decided. Keith Banting, in his contribution to our background document, begins with the following overview of the interaction between pension reform and the political decision-making environment:

> The decision rules which govern any reform process are critical to the kinds of decisions which emerge from it. The rules which determine the way in which authority is shared, and the formal procedures through which policy must be formulated, act as a set of constraints on decisionmakers. Such constraints are never neutral. They inevitably condition the ability of different interests to influence policy decisions, smoothing the way for some and raising obstacles for others. They make some outcomes more difficult to achieve, and others easier.[1]

One purpose of the Banting paper was to note how 'the federal government's Green Paper pays remarkably little attention to the constraints imposed on it by the decision rules',[2] and thus to highlight the importance of these rules. This is also our purpose in the present chapter - to describe the various constitutional and political forces at play in the pension debate and consider how they are likely to influence the outcome. In the next chapter, we shall focus on the implications of pension reform for Ontario and the provinces generally.

In dealing with the federal-provincial overlap in the pension field, our attention is directed in turn to private plans, to the CPP, and to non-contributory programs such as OAS, GIS, and GAINS. As has been the case throughout our document, we shall draw freely and without attribution from the background document, in this case principally from the paper by Banting.

The regulation of private pensions

Although it is correct to say that regulation of occupational pensions is a shared field, the responsibility for establishing standards governing such plans is a provincial responsibility. These standards deal with matters such as vesting, solvency, investment, and disclosure. As noted in Chapter 3, most provinces now have legislation covering the regulation of private pension plans.

The federal government also plays an important role in the occupational pension area. First, the federal Pension Benefits Standards Act regulates pensions for those sectors of the economy that are under federal jurisdiction, such as banking and interprovincial transportation. Second, Revenue Canada establishes guidelines for plans seeking to qualify for deduction of contributions and for exemption of investment income under the provisions of the federal Income Tax Act. Third, Revenue Canada requires that investment plans in provinces that have not as yet enacted pension legislation conform to federal standards.

As the background research points out, this joint responsibility creates a tension between pressures for change on the one hand and pressures for uniformity of pension regulation across the country on the other. While the provinces are free, in legal terms, to alter the regulatory system as they see fit, in practice their ability to do so is somewhat constrained. For one thing, the mobility of labour and capital across the country create pressures for broadly similar standards. For another, businesses that operate on a nation-wide basis strenuously oppose regional variations in pension standards that would create administrative complications for their own plans. Partly as a result, in 1974 the senior regulatory officials established the Canadian Association of Pension Supervisory Authorities (CAPSA) to address the need for harmonization in pension regulations across jurisdictions. Even though CAPSA is not a decision-making body, its consensus positions on pension issues have played a major role in the current pension debate. For example, the excess interest proposal contained in the Green Paper is adopted from a similar CAPSA proposal.

The RPA, to which the Council has already given its support, is an intriguing pension device in the constitutional sense. If it is interpreted in much the same way as an RRSP, the federal government may be able to implement it unilaterally, drawing on the strength of the Income Tax Act.

The question of regulating the kinds of investments that could be made through an RPA might raise some constitutional wrinkles, with the pension regulation function of the provinces running against the investments allowable (for tax deferral) under the Income Tax Act. More generally, the provinces would presumably have a great deal to say about the degree to which and manner in which existing occupational plans would interface with the RPA.

At this juncture, a slight detour is warranted. The income tax system for all provinces except Quebec is a shared federal-provincial system. The federal government collects, free of charge, the provinces' share of the combined tax. At present, this amounts to roughly one-third of the total tax collected. In return, the provinces accept the structure of the tax system (exemptions, deductions) as defined by Ottawa. In this sense, the federal government would presumably have the right to introduce RPAs and incorporate them in the overall structure of the tax system. However, in its recent publication, A Separate Income Tax for Ontario: An Ontario Economic Council Position Paper, the Council recommends that any such major change in the structure of the tax system be decided upon jointly by the federal government and the provinces, since it would have major revenue implications for both parties. The other snag in the assertion that introducing an RPA is a federal prerogative is that Quebec has its own, separate personal income tax system. Hence, federal initiatives cannot bind this province in terms of its own income tax system.

Nonetheless, the RPA does represent an approach to pension reform that may have quite different constitutional implications than more traditional approaches.

A second implication arising from the potential harmonization problem is that it may strengthen Ottawa's hand in arguing for a mandatory expansion of a public pension system - in particular the CPP. However, the Green Paper is rather remiss in not pointing out that the CPP, too, is a shared responsibility. To this issue we now turn.

The management of public plans

Contributory plans: the Canada and Quebec Pension Plans

Under the current arrangements relating to the CPP, any amendments to the plan must be approved by two-thirds of the provinces with at least two-thirds of the population. This sets up a series of multiple vetoes over CPP. First, the federal government can block any change with which it disagrees. Second, any four provinces can block a change. Third, by virtue of its population share (just over one-third) Ontario has a veto in its own right. Finally, because of what must at best be viewed as an anomaly, Quebec is included in the rules governing changes despite the fact that it operates its own pension plan. Thus Quebec and one other province (to make up one-third of the population) can veto any CPP amendment even if all nine other governments are in favour of the change.

In addition, the act setting up the CPP allows any province to opt out and to establish its own plan, in which case the CPP ceases to operate in that province. Only Quebec has thus far opted out.

It may be that underlying the Green Paper is an implicit intention on the part of the federal government to establish a new CPP, which we earlier referred to as CPP II. Whether this is constitutionally possible is open to question, since section 94A of the Constitution Act stipulates that no federal pension plan 'shall affect the operation of any law present or future of a provincial legislature in relation to any such matter'. If interpreted strictly, this provision might tie Ottawa's hands in this matter.

Thus public pension plans as well as private plans operate under divided authority, so again final policy decisions will likely be hammered out in the familiar forum of federal-provincial bargaining.

The Green Paper is exceptionally misleading in not alerting Canadians to the legal and political realities underlying both existing pension arrangements and potential pension reform.

Non-contributory plans[2]

The federal government appears to enjoy complete freedom to operate its non-contributory pension programs such as OAS and GIS,[3] just as Ontario has comparable freedom in mounting programs such as GAINS.

It is ironic that the Green Paper has little to propose in the way of changes in OAS or GIS, respecting which the federal government has complete freedom of manoeuvre, but proposes, unilaterally, changes in the other pension programs, responsibility for which is shared with the provinces.

Keith Banting's paper in our background document makes a very interesting point about the role of these non-contributory programs, particularly GIS. Banting's argument is that the institutional and political barriers to change associated with the CPP and private plans have tended to raise the political importance of the OAS-GIS instrument. For example, GIS was initially instituted as a transitional mechanism for people who would not benefit from the CPP. The role of GIS was expected to diminish as the CPP matured, but instead that role has increased. Indeed, as Banting points out, because of its ability to target benefits, the availability of the GIS is probably now viewed as a barrier to the expansion of the CPP. These issues were dealt with at some length in the previous chapter.

Pensions and the Division of Powers: Council Summary Observations

- Remarkably, there has been very little discussion in the pension debate of division of powers with respect to pensions. The implicit assumption by most participants, encouraged by the Green Paper's silence on this issue, is that pensions are a federal matter. This is not the case.

- In regard to private pensions, the provinces have responsibility for establishing standards governing such things as vesting, disclosure, investment, and solvency. The federal government regulates pensions in those sectors under its jurisdiction and in those provinces that have not legislated their own pension standards. The federal government also exerts considerable influence by virtue of the Income Tax Act, which sets guidelines relating to pension deductibility and the eligibility of investments for tax deferral. Thus responsibility for private pensions is shared between the federal government and the provinces.

- Responsibility for the CPP is also shared. Any amendments to the plan must be approved by two-thirds of the provinces with two-thirds of the population. The latter aspect of this arrangement gives Ontario a veto on all CPP amendments. In the final analysis, however, the CPP is a provincial plan, since the provinces have the option of following Quebec's lead and taking over the operations of the plan. This essential feature of the CPP is effectively missing from the Green Paper.

- RPAs are an intriguing pension device in the constitutional sense. Like RRSPs, RPAs may fall in the federal domain to the extent that they draw their constitutional existence from the Income Tax Act.

- Non-contributory plans such as OAS and GIS appear to fall under federal jurisdiction. Likewise, provincial programs such as GAINS fall under provincial responsibility.

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Implications for Ontario

Introduction

From our brief overview of the political-cum-constitutional realities of pension arrangements, it is clear that the provincial concerns and rights are involved at virtually every turn. The purpose of this chapter is to bring to the attention of the Government of Ontario and to Ontarians in general our province's role and, on occasion, its responsibility in the pension reform process. By the very nature of our mandate, we are addressing ourselves to Ontario. However, as will be abundantly clear in what follows, our comments and observations are likely to be every bit as relevant to the other provinces as well.

Before we embark on this exercise, it is appropriate to review the general thrust of the document. We have come out against both a mandatory expansion of the CPP and its close relative, the 'implicit' federally run CPP II. Instead, we have opted for an RPA-led quality and quantity improvement in private sector plans combined with an improvement in the income support level for the single elderly. This alternative places some responsibility on the provinces, since they have a major role in the regulation and management of private sector plans.

We hasten to add that the Ontario Economic Council is not privy to the official views of the Province of Ontario with respect to pension reform. All that we can say is that, insofar as the Ontario government accepts our underlying analysis, the province will have to give serious consideration to the implications and recommendations outlined below.

As a final introductory comment, we wish to reiterate an enduring objective of the Council: we are committed to enhancing the degree to which Canada can be characterized as an internal common market, i.e., an entity within which goods, services, labour, and capital can move free and freely across provincial boundaries. Pension reform, particularly as it relates to issues such as portability and vesting, is necessary to ensure that labour has increased access to the national market. In a federation as decentralized as Canada and in which responsibility for private pensions rests primarily with the provinces, this requirement transfers a considerable coordination and integration challenge to the provinces.

Ontario and the CPP

Since Ontario has a veto on any changes in the CPP, and also the option of following Quebec's lead and establishing its own version of the CPP, it has considerable leverage on the manner in which this program evolves. The major issues deriving from our analysis relate to the cash-flow position of the CPP over the next few years. It is rather obvious that the short-term interests of provincial treasurers throughout the country would argue for an increase in contribution rates in order to avoid a worsening of the provinces' current fiscal problems. The Council is not against an increase in contribution rates. Indeed, it might be appropriate to have a graduated increase in contribution rates beginning now rather than a sudden large increase later. What we have argued is that if any such increase in contribution rates generates a cash surplus, this surplus should be set aside in a separate fund whose investment would be dictated by market forces. Our rationale is twofold: first, the unfunded liability of the CPP is already daunting enough, and any excess funds from now on should be utilized to maximize returns in order to relieve the burden on future taxpayers; second, while not minimizing the fiscal constraints currently facing all provincial governments, the Council is of the opinion that these fiscal challenges have to be met on their own terms and should not be masked by transferring them to the pension system at the expense of both future pensioners and future taxpayers.

The Council finds it difficult to come up with any firm recommendation with respect to the repayment of the provinces' indebtedness to the CPP system. Perhaps this is as it should be. It is likely to be the case that the resolution of the CPP/QPP funding issue can be dealt with only in the broader context of the overall federal-provincial financial interface. Just as the financial underpinnings of the equalization program have to take into account the existing funding relationships pertaining to the Canada Assistance Plan and the Established Programs (including hospitals, medicare, and post-secondary education), so too should the financing of all of these programs take account of the financial arrangements for the CPP, and vice-versa.

Therefore, the Council recommends that the financial details relating to the CPP/QPP be included in the overall fiscal arrangements package. This would bring all of the major elements of the complex financial interrelationships between Ottawa and the provinces under one rubric. It would also provide an automatic quinquennial review of the pension area. Because of the basic uncertainties of factors such as fertility, mortality, productivity, inflation, and the like, it is important to have in place such a mechanism for periodic review of public pensions.

Ontario and private pensions

Because of their pension regulation function, the provinces have a major role to play in private sector pension reform. Their responsibility here is really a dual one. The first aspect relates to modifications in the regulatory environment in order to implement the various elements of pension reform. The second aspect involves interprovincial coordination and integration. It is not enough for Ontario to improve its own pension delivery system. There have to be fair and equitable transfer mechanisms, so that workers' pensions become portable across the country. This need not imply that pension regulations and standards be everywhere identical. What it does mean, however, is that where differences do exist there also exist reasonable means whereby portability can be ensured. Whether this would require a new interprovincial or federal-provincial pension authority, or whether this objective could be achieved through existing bodies such as CAPSA, we leave to the parties involved. What is required, however, is a recognition on the part of Ontario and the other provinces that along with the constitutional right to oversee private pension regulation must go the responsibility to ensure that the Canadian labour markets become national in scope.

Beyond this responsibility for facilitating greater mobility of labour, Ontario has an important role to play in ensuring that pension reform does not have a negative impact on the functioning of our capital markets. We have already expressed our concern over the Green Paper's specifics relating to the excess earnings proposal. More generally, it is in the interests of Ontario and Canada that the regulatory framework provide maximum flexibility for annuity design, for the growth of new institutions in response to any pension reform, and for pension plans (whether institutional or self-administered) to maintain access to equity markets.

Ontario and RPAs

It is not clear just where constitutional authority lies with respect to the proposed RPAs. What is clear is that the RPA scheme could significantly improve the quality and quantity of private sector pensions. The Council urges the Province of Ontario to work with other provinces and the federal government to ensure that this vehicle is introduced in a manner that maximizes its potential. On Ontario's part, this would mean, among other things, consulting with the private pension industry to seek methods by which RPAs may be integrated and/or co-exist with current occupational plans. To the extent that the regulation of RPAs falls under provincial auspices, the Council urges Ontario to seek maximum opportunity for the owners of RPAs to acquire an ownership stake in our economy. We would suggest that Ontario give consideration to our recommendation that individuals be able to hold multiple RPAs, and that it encourage competition on the supply side of the market for RPAs.

Ontario and GAINS

The Council applauds Ontario's initiative to provide additional income support, via GAINS and the various Tax Grants, for certain segments of the elderly. However, it should be obvious at this point in the document that there are some defects associated with GAINS. Principal among these are the manner in which the benefits for singles and couples are determined and the manner in which GAINS is integrated with GIS.

This is one of the most difficult areas in the entire pension debate. Indeed, there may be no single best approach to the problem of providing sufficient income support for those in need while avoiding the various disincentives that beset the existing arrangements. Intricately bound up with all of this is the whole issue of whether income support ought to be universal or selective.

Based partly on these concerns and partly because the well-to-do elderly are treated too generously by the existing taxation system, we have suggested several approaches to the task of rethinking and reworking the delivery of income support to the elderly. We think that, if the province is also of this opinion, there is plenty of scope for cooperating with the federal government and the other provinces in investigating alternatives to the present system. It may well be that the funds currently devoted to the GAINS program and to Ontario Tax Grants for Senior Citizens could be used more effectively in the context of an integrated overall approach to income support for the elderly.

Ontario and the public sector plans

The Council has recommended that there be much fuller disclosure of all aspects of pensions. Included in this was the recommendation that there also be public disclosure of the various government-run pension plans, particularly as they relate to such items as inflation protection.

Conclusion

In this chapter we have deliberately kept the analysis at a general level. To cite all of the areas of the pension debate in which Ontario has an interest would be tantamount to reproducing the previous chapters.

While it is disconcerting that the Green Paper paid so little attention to the constitutional and institutional setting of pension issues, it would be more disconcerting still if Ontario did not rise to the challenge and responsibility of pension reform. Because of the size of our province and because of our industrial structure, Ontario has to take a key role, perhaps a leadership role, in the reform process from here on in. This is not an easy task. It includes regulatory reform within the province of Ontario. It includes a coordinating and integrating role across the various provincial jurisdictions. Finally, it must also include close cooperation with the federal authorities, both in terms of designing an overall pension environment and in terms of sorting out areas such as the GIS-GAINS overlap so that the pension delivery system is made more effective and equitable.

Implications for Ontario: Council Summary Observations

- Constitutionally, Ontario has a role, perhaps a leadership role, in virtually every aspect of pension reform.

- The Council cannot speak for the Province of Ontario. However, to the extent that Ontario agrees with the thrust of our document, the province should give serious consideration to the implications that flow from it.

- With respect to private pensions, Ontario will have to modify its regulatory environment to accommodate the recommendations relating to vesting, disclosure, inflation protection, and the like. What is even more important, Ontario and other provinces must strive to ensure that there is far greater pension portability in the system so that labour markets become truly national in scope.

- If RPAs are introduced, Ontario will have to take an active role in ensuring that the new pension instrument lives up to its potential. This would mean working with the federal government to ensure that RPA holders had maximum opportunity to acquire an ownership stake in the economy, to encourage competition on the supply side of the RPA market, and to ensure that RPAs could be integrated and/or co-exist with existing occupational plans.

- With respect to the CPP, we encourage the Province of Ontario to take the lead in ensuring that any future CPP cash flow is invested in financial instruments that maximize rates of return.

- With respect to GAINS, it is clear that the province can improve this program. There is scope here for Ontario and the other provinces to work together with the federal government in redesigning the income support system for the elderly.

- Ontario should consider full disclosure of all aspects of Ontario public sector pension plans.
- Finally, since the federal-provincial financial implications of pensions, particularly the CPP/QPP, have become so significant, the Council recommends that pension reform become an integral component of the quinquennial review of federal-provincial fiscal arrangements.

Part VI
Conclusions

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Conclusions

In the previous chapters we have presented the background, the issues, and our recommendations relating to a wide range of areas coming under the umbrella of pension reform. It is not our intention in this concluding chapter to provide a capsule summary of the pension reform debate: this is readily available from the series of Council Summary Observations which appear at the end of the respective chapters. However, there are a few items that merit further attention, either because of their inherent importance to the overall discussion or because the structure of our presentation has not crystallized these issues as clearly as ought to be the case.

We shall limit ourselves to five such items. The first relates to what is sometimes referred to as the Green Paper's 'hidden agenda', namely the possibility that the role of the federal document and the public hearings of the Parliamentary Committee is to prepare the ground for an expansion of the Canada Pension Plan, perhaps in the form of a federally run pension system, labelled earlier as CPP II.

The second general issue relates to the 'adding up' problem, as it were. In each of the chapters, we have assessed the pros and cons of the various arguments and have generally come down with a recommendation of one sort or another. In global terms, what are all these recommendations likely to imply about such things as individual choice and economic costs? These will be discussed under the general heading 'Paternalism and Pensions.'

Third, we shall focus on the range of alternatives relating to the position of the current elderly. Much of the analysis of any major changes in pensions runs up against and is even constrained by the set of arrangements presently utilized to deliver income support.

Fourth, we shall argue that pension reform ought to be more of an ongoing process than it has been in the past. We shall make one recommendation toward this end.

Finally, we shall return to a theme that has probably been well covered, but that is a fitting one with which to conclude, namely the role of pensions and provinces in creating a national labour and capital market.

The 'hidden agenda': doubling the CPP

There is no question that the first issue the Parliamentary Committee will have to address is whether or not to recommend a mandatory expansion of the public pension system.

This is probably the critical issue in the pension debate.

The Council recognizes that some advantages would attend such an expansion. However, on balance we have rejected the initiative. The following points summarize our position:

- An expanded CPP does not address the immediate priority in the pension debate, namely the distribution of income support between elderly individuals and couples, and the likelihood that for some of the former the present support levels are too low. Making any new CPP entitlements retroactive would exacerbate the single-couple distribution and in any event would not direct itself to those elderly who are not eligible for CPP.

- Under existing arrangements, an expanded CPP would not do much for the retirement income of low-income individuals. The difference between a full CPP at maximum level and no CPP at all for a single earner couple is on the order of $150 per year. However, these same persons would see their income during their working lives reduced because of CPP contributions, and perhaps their job prospects would be reduced as well. In other words, the CPP, under existing arrangements, is not only a regressive tax but it almost assuredly has the impact of reducing the lifetime income of low-income workers.

- The current CPP embodies a tremendous subsidy to the current generation of workers. When mature, the CPP contribution rate could well be three times the present rate. An expanded CPP, unless fully funded, would embody a similar transfer to the next generation. Since the full subsidy would accrue primarily to those who were already currently well off (see the above point), there is no reason whatsoever why we should transfer the cost of this subsidy to future generations of workers, both rich and poor.

- Much of the underlying argument for an expanded CPP runs in terms of generating adequate replacement ratios. However, our analysis suggests that replacement ratios are already very high, on average, for those earning the Average Industrial Wage. Those who have earnings above this level are, in our view, capable of looking after their own retirement and in any event likely have access to RRSPs, which have literally mushroomed in terms of the numbers of Canadians who now make contributions to them. To be sure, there are some Canadians who do not have access to private pensions. These groups warrant concern. The RPA scheme could solve the problems of some of them. Overall, it is our view that a compulsory expansion of the public pensions is not warranted on these grounds, given the negative aspects of such an expansion.

- The cost of the existing CPP will be difficult enough for future generations to bear. Doubling this cost in an environment in which fiscal resources are already a serious concern seems wholly inappropriate. To the extent that, for demographic or other reasons, the cost of the future liabilities of the present CPP are underestimated, it is also the case that the future liabilities of the OAS-GIS combination and the future costs of providing health care to the elderly are underestimated. Both OAS-GIS and health care costs are currently much larger than CPP costs and will in all likelihood continue to be larger even when the CPP matures. Given this substantial cost uncertainty, the notion that Canada should double or at least significantly increase the CPP is unacceptable.

- One of the appeals to governments of an expanded CPP is that the initial excess of contributions over benefits can be brought into general revenues for current budgetary purposes. The Council rejects this notion of applying pension surpluses to service current fiscal needs. It neither enhances present fiscal planning nor ensures a fair and adequate return to either future pension contributors or future recipients.

In summary, we are of the opinion that these issues have not been adequately addressed in the pension debate. In our opinion, they tilt the scale strongly against a mandatory expansion of the public pension system.

Paternalism and pensions

As noted in the introductory chapter, an underlying theme of the pension debate is the nature and role of the state in the next century. An expanded CPP with annual excesses turned over to governments would produce a radically different environment than a private pension system dominated by RPAs. The issue here is, in large measure, whether individuals or governments will control the pools of capital that will influence our economic future. At stake also is the trade-off between government compulsion and individual choice. It is on some elements of this choice-vs.-compulsion tug-of-war that we shall focus in this section.

Consider the impact of the various recommendations on the level of contributions or benefits. First, the provision for inflation protection would reduce substantially the level of benefits received immediately after retirement compared with a non-indexed annuity. This reduction would be all the larger unless the markets for inflation-protected annuities were improved. Second, any requirement that annuities have to be of a joint-and-last-survivor nature would also tilt overall benefits away from the present and toward the future. Mandatory credit splitting would do the same thing for the CPP. Third, features designed to enhance future retirement benefits, such as earlier vesting and increased portability, would likely be paid for by the workers, in the form of either greater contributions per dollar of benefits, or smaller benefits per dollar of contributions.

Thus, the cumulative impact of all of these changes on, say, the initial level of benefits could be quite dramatic. This would be particularly true with respect to those individuals who, over the years, had made alternative arrangements to take account of the fact that the current system was lacking in certain respects. Life insurance protection in lieu of joint-and-last-survivor annuities is a case in point. Requiring such individuals to purchase joint-and-last survivor annuities would inflict upon them a substantial decrease in living standard, in part because they had the foresight to provide themselves with an alternative source of survivor benefits.

The implications of all of this for pension reform are at least threefold. First, wherever possible, individuals or family units should be able to substitute alternative arrangements for any recommendations emanating from pension reform. Second, where reform measures must be of a compulsory nature, some lead time must be allowed to give people an opportunity to adjust to the new arrangements. Finally, reform measures should not be retroactive. These are not onerous requirements when it is realized that provisions for retirement income involve contracting over one's working lifetime.

Income support arrangements

While the Council has concluded that some segments of the current elderly, particularly singles who are renting, deserve more income support, we have also recognized that the overall income support system for the elderly is poorly designed. The high tax-back rate on GIS, made confiscatory by the manner in which Ontario applies its own income-tested program, not only creates a set of inappropriate incentives but also severely restricts the types of longer-term reforms that can be implemented. Moreover, at the upper income levels, the treatment of the elderly is too generous. It just does not make economic sense for an elderly couple with an income in the mid-$30,000 range to be exempt from all net income taxation. And in the Ontario context it also appears inappropriate to exempt persons in this income class from medical and hospital premiums.

Earlier in the document we suggested several alternative proposals that would alter the current arrangements. It is becoming more evident that some modification is essential. It is important in its own right, but it is even more important in terms of implementing any major pension reform, whether in the private or the public system. It seems to us that this issue ought to be tackled prior to embarking on many of the recommendations. If the delivery of income support is rationalized, it becomes much easier to design other reform measures and to integrate them with the overall pension system. Hence, we recommend that serious further consideration and research be devoted to rethinking, if not redesigning, the income support system for the elderly.

Pensions and fiscal arrangements

The present pension debate is the first major attempt at pension overhaul since the introduction of the CPP/QPP in the mid-1960s. The Council believes that the process of pension reform ought to be undertaken in a more continuous manner. Moreover, the federal-provincial financial stakes in the pension game are now so large that it is inconceivable that they can be sorted out without reference to the other major federal-provincial financing programs. Both of these objectives would appear to be met formally by the inclusion of public pensions within the preview of the Fiscal Arrangements Act. Although it may be preferable to contemplate major pension appraisal in the course of, say, every second negotiation of fiscal arrangements, the five-year nature of these financing provisions does allow for periodic up-dates of pensions. Moreover, as noted above, the financial implications relating to pensions should be incorporated in the overall arrangements relating to the financing of the other major intergovernmental programs, such as equalization, post-secondary education, medicare and health insurance, the Canada Assistance Plan, and the Tax Collection Agreements.

As noted in Chapter 15, there is also a need for Ottawa and the provinces to sort out the manner in which the various CPP/QPP benefits relating to disability and under-65 survivor benefits will be integrated with the various existing social programs. This is not a matter that need be incorporated into the quinquennial fiscal arrangements deliberations, but it is probably best sorted out in the context of a federal-provincial conference called for this purpose.

Preserving the internal common market

In conclusion, we wish, again, to reiterate our position with respect to the notion that the domestic market ought to be characterized by free mobility of labour, goods, and capital. In the context of pension reform, the implications are most obvious when it comes to labour mobility. However, since the pension funds are also among the largest sources of capital in the economy, pension reform also has a great deal to do with the degree of mobility inherent in the flows of capital. The Council's oft-stated position is that Canadians wherever they live have a right to move themselves and their capital anywhere in the nation. Since the provinces have constitutional authority over much of the pension area, they have a special responsibility in this regard.

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Council Dissenting Views

CLIFFORD G. PILKEY

We appreciate the considerable amount of time and energy the Chairman and staff of the Ontario Economic Council have devoted to the subject of pension reform. Although we agree with some points in the OEC submission, its main thrust, unfortunately, is incompatible with our position and that of the CLC, and therefore we cannot endorse it.

The Chairman has been kind enough to accept an appendange of our demurral in the form of the following 24 recommendations, further elaboration of which is contained in the OFL submission to the Task Force:

1. That the level of benefits under the Canada and Quebec Pension Plans be increased to 50 per cent of earnings up to the Average Industrial Wage ($20,300 in 1982).

2. That the basic Old Age Security pension be increased to 17.5 per cent of the Average Industrial Wage.

3. That the maximum level of benefits under the Guaranteed Income Supplement program be increased to 17.5 per cent of the Average Industrial Wage for a single person and 10 per cent of the Average Industrial Wage for each member of a couple.

4. That all public pensions should increase automatically with improvements in the standard of living.

5. That the minimum guarantees produced by Old Age Security and the Guaranteed Income Supplement be available to persons aged 60 and

over who are unemployed or widowed.

6. That accrued benefits under the Canada and Quebec Pension Plans be subject to automatic credit-splitting on the retirement of the younger member of a couple or in the event of marriage breakdown.

7. That the survivor's pension under the Canada and Quebec Pension Plans remain at 60 per cent of the deceased spouse's pension (after credit-splitting).

8. That years spent caring for children under seven be excluded from the calculation of benefits under the Canada and Quebec Pension Plans.

9. That the Canada and Quebec Pension Plans be funded on a pay-as-you-go basis.

10. That Canada and Quebec Pension Plan contributions be payable on all earnings and that tax revenues released by reducing costs under the Guaranteed Income Supplement be used to help pay for the CPP/QPP.

11. That private pension benefits be vested after 5 years of service and that deferred benefits be indexed on the basis of excess interest earned by pension investments.

12. That all private pension payments be indexed on the basis of excess interest earned by pension investments.

13. That a Central Pension Agency be established for the administration of vested, deferred benefits.

14. That employee contributions be credited with interest comparable to that obtained on deposits for a similar period with a savings bank.

15. That all pension plans be required to provide a survivor's pension of at least 50 per cent without reduction of the initial level of pensions.

16. That legislation provide for a maximum eligibility period of one year

and that part-time employees working 1,000 hours or more in a year be eligible.

17. That continuity of service for pension purposes not be interrupted by lay-offs, industrial disputes, sickness, or disability of less than six months' duration.

18. That every pension plan participant receive an annual statement indicating his/her accumulated credits and contributions; the current balance of liabilities and assets; total employer and employee contributions in the last year.

19. That every employee and union be entitled to receive the following additional items of information upon request:

    - the full text of the terms and conditions of the plan;
    - the full text of any agreement effecting the administration of the funds;
    - an annual financial statement describing the status of the fund including how it is invested;
    - a copy of the most recent actuarial report;
    - a copy of any other statements required by law to be filed with the Pension Commission;
    - an actuarial gain and loss statement based on the most recent actuarial valuation.

20. That there be legal recognition of the right of a union to negotiate on behalf of its retired members and of the responsibility of employers to bargain in good faith on all related matters.

21. That legislation require the establishment of joint employee-employer boards or administrative committees where either party so desires.

22. That no modification of a private pension plan result in the reduction of the value of benefits accrued to the date of change and that the 'benefit step rate' and the 'benefit offset' methods of integration be prohibited.

23. That a system of fund insurance be established with adequate measures to prevent employers from avoiding their obligations.

24. That government should provide on-going financial support for pre-retirement counselling programs.

Social justice and equity for our elder generations can only be achieved if we provide mechanisms so that they can maintain an adequate level of income throughout retirement. Our basic conclusion is that we need a broader foundation of social security. Public programs must be the centrepiece of Canada's retirement income system.

Notes

Chapter 3

1 Hart Clark (1980) 'A comparison of the retirement income systems of Canada and other countries'. In Task Force on Retirement Income Policy, The Retirement Income System in Canada, (Ottawa).

2 Alan Blinder, 'Private pensions and public pensions: theory and fact', NBER Working Paper 902, p. 18.

3 Henri-Paul Rousseau and Francis Taurand (1983) 'Taxes sur la masse salariale et emplois: le cas du Québec'. Cahier 3809, Faculté des sciences sociale, Université Laval.

4 Business Committee on Pension Policy (September 1983) Canadian Retirement Income Policy: A Consensus Brief, p. 16.

5 Ibid.

Chapter 4

1 Business Committee on Pension Policy (September 1983) Cost Study, p. 25.

2 Note that while the marginal tax-back rate is 100 per cent, the average tax rate is negative. This is very clear from Tables 21 and 22 below. In other words, these income-tested programs make low income persons better off and leave unaffected the position of higher-income individuals. What is of concern here is not the existence of these income-tested benefits but rather their structure. Chapter 17 proposes some alternative approaches that incorporate lower tax-back rates. However, it is also possible to take the other view, namely that GIS ought to be offset 100 per cent by any CPP benefits, since one reason GIS was introduced in the first place was to provide a bridge of minimum income for those too old to qualify for CPP benefits. More on all this later.

Chapter 6

1 This is adopted from the National Council of Welfare (1982) Financing the Canada Pension Plan (Ottawa) p. 18.

Chapter 7

1 Much of the analysis in this chapter is taken directly from the background study by John Whalley and Colleen Hamilton, *'Reforming public pensions in Canada: issues and options'*.

2 Statistics Canada (1982) *Income Distribution by Size in Canada 1980*. Catalogue 13-207 Annual (Ottawa) p. 120.

3 *Ibid.*

Chapter 8

1 Clark, *op. cit.*

2 *Ibid.*, p. 2:10.

3 Frank Denton, Melvin Kliman, and Bryon Spencer (1981) *Pensions and the Economic Security of the Elderly* (Montreal: C.D. Howe Institute) p. 77.

Chapter 10

1 This includes the Ontario Federation of Labour. See the dissenting view appended to our document by Council member, and President of the Ontario Federation of Labour, Clifford Pilkey.

2 House of Commons (1 June 1983) *Minutes and Proceedings and Evidence of the Special Committee on Pension Reform*. Issue No. 13.

3 House of Commons Appearance by Honourable Monique Bégin before the Parliamentary Committee on Pension Reform, *Ibid.*, Issue 1, p. 25.

Chapter 13

1 James E. Pesando (1983) *The Use of 'Excess' Pension Fund Earnings to Provide Inflation Protection for Private Pensions* (Toronto: Ontario Economic Council) p.2.

2 *Ibid.*

Chapter 14

1 Canadian Association of Pension Supervisory Authorities (CAPSA), *A Consensus for Pension Reform*.

2 Ontario Status of Women Council (September 1983) 'Women and Pensions'. Brief prepared for the Parliamentary Task Force on Pension Reform.

3 Parts of this section draw upon a recent paper, 'Unisex - is this an answer to sex discrimination?', prepared by Robin Leckie, Senior Vice President and Chief Actuary, Manufacturers' Life Insurance Company.

4 Cited in 'Women and Pensions' *op. cit.*, p. 15.

5 Monica Townson (1983) 'Pension reform for women'. OEC background study.

6 Marie Corbett (1983) 'The impact of pension reform on women's employee pension plans'. OEC background study.

Chapter 16

1 For an elaboration of this point, see Ontario Economic Council (1983) A Separate Personal Income Tax for Ontario: An Ontario Economic Council Position Paper (Toronto: Ontario Economic Council) ch. 7.

2 Trusteed pensions include those plans where contributions and savings are converted into invested assets and where pension payments and other costs are paid out of these funds. The actual trustee may be three or more persons, a trust company, or a pension society. Effectively, trusteed plans include the first two categories of Table 20 below.

3 Business Committee on Pension Policy (September 1983) Capital Markets Study, Table 2.1.

Chapter 17

1 J.R. Kesselman (1980), 'Pitfalls of selectivity in income security programs'. Canadian Taxation 3, pp. 154-63.

Chapter 18

1 The 1982 Society of Actuaries Pension Committee (forthcoming) 'Effect of deferred retirement on pension plan liabilities and costs'. Transactions: Society of Actuaries.

2 Thus, the figures in the table are the cost and benefit implications after this 3 per cent annual increment is taken into account.

Chapter 19

1 Keith Banting (1983) 'The decision rules: federalism and pensions reform'. Ontario Economic Council background study.

2 While OAS and GIS are currently noncontributory, it is instructive to recall that, originally, OAS was financed by 2 percentage points of the personal income tax, 2 percentage points of the corporation tax,and 2 percentage points of the sale tax. Thus, OAS was considered 'contributory' in the sense that taxes were 'earmarked' for its financing.

3 There is some question as to the federal government's freedom to manouver even in the area of old age pensions (OAS). Section 94A of the Constitution reads:

> 'The Parliament of Canada may make laws in relation to old age pensions and supplementary benefits, including survivors' and disability benefits irrespective of age, but no such law shall affect the operation of any law present or future of a provincial legislature in relation to any such matter.'

Just how the courts would interpret this is open to question. We are unwilling and indeed unable to render a judgment on this issue.

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PENSIONS TODAY AND TOMORROW

AN ONTARIO ECONOMIC COUNCIL POSITION PAPER

EXECUTIVE SUMMARY

The Council's Priorities

The Council's priorities in the pension area are: (1) enhancing income support for those elderly currently most in need; (2) ensuring that workers earning the average industrial wage or below have fair and adequate access to retirement savings instruments; and (3) ensuring that all Canadians have access to retirement savings vehicles that allow post-retirement income to maintain a reasonable relationship to pre-retirement income.

Expansion of the CPP

The most critical decision in the pension area is whether or not the CPP should be expanded. The Council is against such a move. First of all, an expansion of the CPP would not address the pressing issue of inadequate income support among the current elderly. Secondly, under the existing tax-back relationships associated with the GIS and GAINS, an expanded CPP would be of least benefit to low-income workers. Third, the existing CPP already embodies a tremendous transfer of costs to future generations. An expansion would exacerbate this transfer to the current generation from future generations, both rich and poor. In place of a mandatory CPP expansion, we propose a quantity and quality improvement of private sector pensions combined with enhanced access to retirement savings instruments for lower-income Canadians.

RPA's

The Council endorses the Green Paper concept of a Registered Pension Account (RPA). In effect, this is an RRSP-type instrument which would accommodate employer as well as employee contributions. Such an instrument would (a) substantially increase pension coverage; (b) accommodate portability since the pension would be run by the worker rather than the employer; (c) provide stiff competition for some existing pension plans that are less than adequate; (d) enhance pension awareness; and (e) allow workers to participate in the ownership of the Canadian economy.

Inflation Protection

The Council is in favour of incorporating a greater degree of inflation protection in pension annuities. We propose a preferred alternative to the Green Paper's recommendations in this regard. However, we are not in favour of compulsory inflation protection - at the very least a pensioner should have the flexibility of opting for a variable or escalating annuity.

Fairness and Access

The Council recommends earlier vesting and enhanced portability. We register some concern about locking in all pensions when they are vested. This issue requires further research.

In terms of RRSP and RPA contributions, the Council recommends that consideration be given to allowing a minimum lifetime guaranteed level. This means that if persons experience an upturn in income later in life, they be allowed to contribute retroactively up to this minimum level. Moreover, consideration should be given to allowing RRSP contributions to be treated as a refundable tax credit so that all income classes are encouraged to save for retirement. At present, RRSP contributors are concentrated in the upper income level.

Spousal Concerns

The Council is in favour of mandatory survivor benefits unless waived in writing by both partners. For death prior to retirement, the spousal benefit should be the full value of the contributor's accrued pension. In terms of the CPP, credit splitting on marriage dissolution appears appropriate.

The Council is against homemakers' pensions. In terms of ensuring greater coverage for women, the Council feels that the RPA's will provide an important thrust. More generally, however, lower female coverage is in large measure due to their lower income levels. Governments must exert all efforts to ensure the women have full access to job opportunities and comparable incomes. If females current earnings improve, so will their pension coverage and future (retirement) earnings.

Replacement Income

Our research suggests that for those who earn the Average Industrial Wage (AIW) replacement ratios are on average, very adequate, averaging about 100 per cent for one-earner couples for example, and somewhat less for two-earner couples. For those earning one-half the AIW, replacement levels are in excess of 100 per cent. The Council's opinion is that Canadians should have ample access to retirement savings vehicles in order to achieve the replacement level they desire. Compulsory replacement ratios are inappropriate.

Income Support for the Elderly

The current situation indicates that the single elderly need enhanced support. The cost effective solution for this is the income tested Guaranteed Income Supplement (GIS). However, the Council also suggests that the wealthy elderly are treated too generously under the income tax system. At a minimum, the age and pension deductions ought to be phased out in order to ensure that income support is directed to those who are most in need.

Provincial Responsibilities

The federal Green Paper was remiss in not pointing out that at almost every term the provinces have a constitutional role in pension arrangements. Among the many suggestions that the Council makes in this regard, the most important one is that the provinces move to ensure that the markets for capital and labour become national in scope. Among other things, this requires that the provinces cooperate to ensure that there is full pension portability across jurisdictions. Moreover, the Council recommends that, if there are any future surpluses in the CPP, Ontario give serious consideration to investing these funds in market instruments, unlike the case with the existing CPP funds.

Conclusion

The Council believes that pension arrangements must remain flexible. Changes should not be introduced retroactively. Indeed, they should only be introduced with an adequate lead time to allow individuals and families to adjust to the new environment. The Council is also of the opinion that pension reform take cognizance of the current state of the economy. Thus we argue that pension assessment be undertaken on an on-going basis, perhaps as part of the existing federal-provincial five-year negotiations with respect to fiscal arrangements.

POOR

QUALITY

ORIGINAL